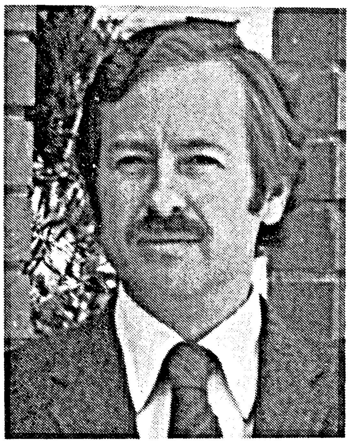
MANAGEMENT CONTROL IN INTERNATIONAL BUSINESS OPERATIONS



Bestuursbeheer van internasionale teenoor tuisbedrywe is in sommige opsigte kwalitatief anders en kwantitatief komplekser. Dit is veral waar van die beheer van die dogtermaatskappy se bestuur deur die korporatiewe hoofkantoor, anders as in die geval van die dogtermaatskappy se bestuurder se beheer oor sy eie maatskappy. In hierdie artikel konsentreer die skrywer hoofsaaklik op die beheer van buitelandse dogtermaatskappye deur die moedermaatskappy, eerder as op die beheer van afsonderlike dogtermaatskappye se beheer deur laasgenoemde se hoofbestuurder. Laasgenoemde gebied bied egter eweneens interessante en duidelik onderskeibare probleme betreffende verskille in plaaslike kulture, vaardighede en tegnologie.

Cedric L. Suzman
Associate Professor
College of Industrial Management
Georgia Institute of Technology

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Management control of international as opposed to purely domestic operations is, in some respects, both qualitatively different and quantitatively more complex. This is particularly true of the corporate headquarters control of the subsidiary management, as opposed to the subsidiary manager's control over his own operation. This article concentrates primarily on the control of the foreign operations by the parent, rather than on the control of the individual subsidiary operations by the subsidiary general manager, although the latter area also presents interesting and distinctive problems relating to the differences in local culture, skills, and technology.

Foreign direct investment by American companies, while by no means a new phenomenon, has nevertheless increased substantially in the past twenty years. The advent of the U.S. firm on the foreign business scene has often been viewed with only grudging acceptance and even plain alarm, by local businessmen. The most often heard fear concerns the superior competitive strength of the subsidiary of a multinational company through access to resources and technology which are not available to a purely local competitor.

The subsidiary of a large multinational corporation obviously does have special access to capital, management skills, and advanced technology. However, the degree to which the corporation can be successful in taking advantage of its position, depends largely on the headquarters management's ability to control a decentralized organisation. In these circumstances, the design and use of a management control system plays a critical role in the efficient and effective management of the foreign operations. It is the major means by which the multinational corporation can ensure that it is more than merely a group of individual investments, each trying to optimize its own position and ignoring the common good of the corporation as a whole.

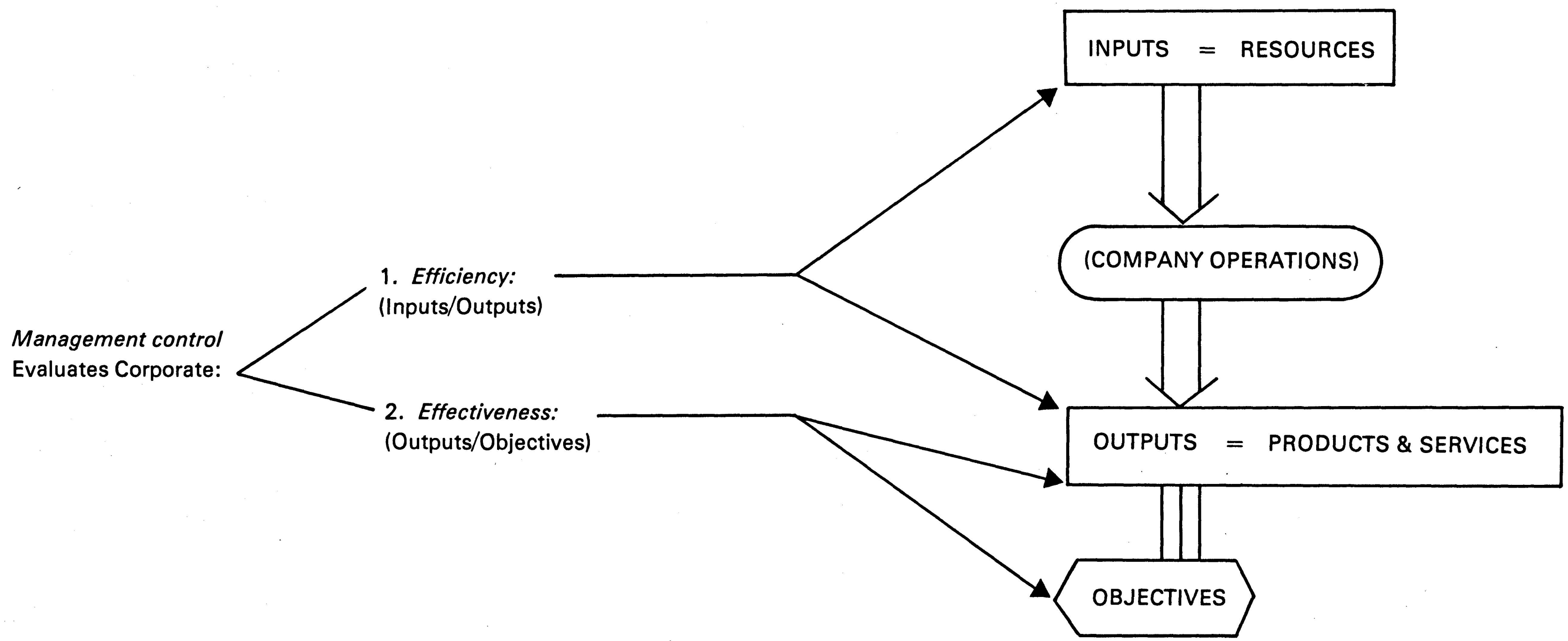
1. A definition of Management Control

Before examining some of the distinctive factors in international business which influence the management control of foreign operations and distinguish it from its purely domestic counterpart, it would be best to clarify what is meant by management control. This is particularly necessary since there are many competing definitions and interpretations of management control currently in use.

Management control in a company is taken to be the process by which management plans for the implementation of the corporate objectives and goals, and then evaluates the efficiency and effectiveness with which the company operates in achieving these goals. Efficiency relates the use of resources or inputs to the outputs or products and services produced. Effectiveness relates the outputs to the goals set for the company and its subdivisions. One of the major objectives of the management control system is to encourage managers to take actions which are in the best interests of the company as a whole.

Table I

THE PURPOSE OF MANAGEMENT CONTROL



Anthony[1] deals with the semantic and at the same time real problem of defining "management control". The problem seems to arise because in the past the function of "control" has been distinguished from that of "planning", whereas in actuality there is an element of planning within the control function. Planning itself can be divided into two parts. The first part is concerned with determining the organization's goals and objectives, and is part of the long-range (strategic) planning process. The second part is concerned with short-range (say, 1 to 5 year) planning for the continued operation within the given corporate, subsidiary, or product division, mission or charter. It is this second type of planning which is an integral part of the management control function. Professor Anthony therefore defines "management control"[2] as:

> The process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organization's objectives.

There are a number of purposes which management hopes to achieve through the use of an efficient and well conceived control system. No control system can, however, achieve all these purposes equally well, and a company must order the purposes in importance so that the control system can be designed to emphasize the more important ones.

Management control is thus the process employed by management to:

(a) *Specify* the goals it wants the organization to achieve at each management level, and *formulate* the plans for achieving the goals.
(b) *Communicate* these goals and plans to personnel responsible for their accomplishment.
(c) *Motivate* or influence individual managers to lead their organizational units or responsibility centers in achieving these goals as efficiently as possible, and to take actions which are in the best interests of the company as a whole.
(d) *Coordinate* activities of the organizational units both vertically along lines of responsibility, and horizontally between units.
(e) *Measure* the performance of the organizational units; *evaluate* the degree to which the goals have actually been realized, and with what effeciency.
(f) *Diagnose* or identify areas of unsatisfactory performance for management attention and action.
(g) Provide *training* and a *learning* environment for managers primarily through the planning and evaluation process.

Table II

MANAGEMENT CONTROL IS THE PROCESS EMPLOYED BY MANAGEMENT TO:

a. Specify goals and formulate plans.
b. Communicate the goals and plans to managers.
c. Motivate managers to achieve corporate goals.
d. Coordinate activities of organizational units.
e. Measure and evaluate performance.
f. Diagnose areas of unsatisfactory performance.
g. Provide training and a learning environment.

The above purposes of a management control system are achieved through the use of a variety of means such as forecasting, budgeting and budget review procedures, procedures for reporting actual operating results, selection of reported data and bases for evaluation of performance, remuneration and reward systems for management, and organization of the controller's department. It should be stressed, however, that the control process is carried out by people in order to control the activities of other people. It is not, and cannot be, a mechanistic or programmed process, and relies heavily on the human relations skills of the managers involved. Management control draws as much on the discipline of social psychology and an understanding of human behaviour as on management accounting and quantitative methods.

The management control process described above is concerned with the total operation or performance of the company and its organizational units. The substance of the control reports therefore relies heavily on financial data to allow integration of market, production and accounting reports. Non-financial data such as unit sales, market share, production efficiency, or employment are clearly also a valuable and necessary part of the measurement system.

II. Distinctive Factors in International Operations

The operations of the foreign subsidiaries involve the movement of capital, goods, services, and people across national boundaries, and the transactions are carried on in more than one currency and in more than one economic, cultural, and social environment. Operating in more than one country also necessitates taking into account more than one set of government regulations, systems of taxation and accounting practices, and a more complex organizational structure. There are thus many additional problems in doing business in more than one country, and most of them impinge on some aspect of the management control process.

Table III

DISTINCTIVE FACTORS IN INTERNATIONAL BUSINESS OPERATIONS

1. Movement of capital, goods, services and people across national boundaries.
2. Transactions are carried out in more than one currency.
3. The business operates in more than one economic, cultural and social environment.
4. The business is subject to more than one set of government regulations, systems of taxation and accounting practices.
5. The company generally has a more complex organization structure.

The practice of management control in the United States appears to be more advanced and sophisticated than in the other industrial countries, with exeption, perhaps, of the larger foreign based multinational corporations. This is not only because business management techniques in general are more advanced. Other factors in the United States which have put a premium on complete, timely, information rather than experience are probably the larger size of U.S. companies, the greater incidence of "professional", non-owner management, and top level executive mobility. In Europe, for example, top management responsibility was often vested in a family head or experienced "old-timer" who has made the particular business his life. Such a manager could use less formal means to keep in touch with what was happening in the business. The development of comprehensive management control systems in the United States has also accompanied the trend towards decentralization of management authority and responsibility.

It is generally the larger more complex companies which have foreign operations, and top management is likely to be of the professional non-owner type, and cannot be intimately acquainted with every facit of operations. Moreover, even if authority and responsibility are not delegated to any degree to local country managers, the company is perforce geographically decentralized. Under these circumstances, the formal management control system plays a critical role in the efficient and effective management of international business operations. It is an important means by which the chief international executive acquaints himself with information or problem areas and opportunities in the business.

One of the problems of top management is that it has been virtually impossible to draw on comparable foreign control practices which could assist in the design of the international control system. The design has been largely left to men whose training and experience is entirely American, and often only in the domestic operations of the particular company. There is thus a danger of applying already established U.S. domestic techniques to the new and substantially different international situations without sufficient analysis and thought. For example, the order of importance placed on the various purposes of the management control system may be different for international operations, or the primary factors on which performance of the subsidiary managers are evaluated, could be different.

The impact of some of the distinctive international factors on the control system is discussed under the following headings:

- — Currency and Exchange Rate Problems
- — Accounting and Business Practices
- — Economic Environment
- — Government Regulations
- — Socio-Cultural Differences
- — Organizational Structure and Corporate Strategy

1. Currency and Exchange Rate Problems

Operating in a number of different currencies requires that the financial statements of a subsidiary be translated into the common yardstick of the parent's currency. The accounts should be translated so that the profit or change in net worth of the parent's investment can be measured in dollars; to facilitate comparison between subsidiaries and allow consolidation with the corporate accounts; and so that the results can be understood by corporate management used to thinking in dollars. However, when the exchange rate between the currencies of the subsidiary and the parent change over time, a problem arises as to the appropriate rate to use in translating the subsidiary accounts.

The ideal objective is to use a method which will reflect separately both the operating results and the effect of the change in exchange rates. Many companies adhere to "accepted accounting practice" approved by the AICPA and use the "current asset"[3] method of translation for external reporting. However, this accounting method is not necessarily useful for internal management purposes. A possible consequence could be a concentration by local management on maximizing local currency profit, while the parent objective may be to minimize the subsidiary's exposure to devaluation through appropriate management of net monetary assets. Whether a subsidiary's management would respond in this manner to different reporting methods is conjectual. The "current asset", "financial asset", and "net asset" methods of translation do, however, assume different assets and liabilities to be affected differently by devaluation, and the reported "loss from devaluation" will be different in each instance. The most appropriate method of translation should be determined by taking into account the economic environment and the goals or objectives of the company with respect to its foreign operations.

In an economy with an unstable exchange rate, planning and budgeting for the operations will have to take into account the probability and the extent and timing of future devaluations, and the possible impact of exchange control regulations. In particular, sources of finance, transfers of raw materials, allocation of production between producing units, and sources of supply, will all be affected. The manager in such an economy will therefore need a greater understanding of financial and monetary problems than his domestic counterpart. A control system requiring *local* translation of accounts into dollars and a formal review of the impact of economic variables on company operations, can help to give the manager the extra competence required and show the impact of his actions on dollar profits, and especially on dollar liabilities and cash payments.

2. Other Economic Environmental Factors

Operating in more than one economic environment has the greatest impact on the planning and evaluation aspects of the control process. Many foreign economies tend to be less stable and show greater variability in performance than planners are used to in the United States. A multinational company may be operating in economies with diverse per capita income and rates of growth, making inter-subsidiary comparisons of little value, and domestic standards of performance will seldom be applicable. Even in economies with similar overall characteristics, government planning and economic development policies will vary, and at any point of time they may be experiencing different economic conditions and problems.

In a purely domestic company, such general economic factors come into what Kindleberger calls the "economic horizon" of the businessman, and the top corporate executives can ensure that appropriate policies are pursued by the subsidiaries. However, as Kindelberger states[4] "there must be some limit to the economic horizon that the businessman is asked to scan." In a multinational company, therefore, more formal means must be adopted to acquaint top headquarters management with local economic conditions for each subsidiary. For example, the reporting system should indicate the advent of balance of payments troubles and the likely means of adjustment, so that timely action can be taken. There are many variables to watch and analyze, and the job cannot adequately be left to *ad hoc* investigation. Rather, the relevant variables should form a part of the regular reporting system.

The effects of inflation and changing price levels on the reported profits, in local and parent company currencies, has been widely discussed by accountants, but with little agreement as to the best practice. AICPA standards still require accounting for external reporting to be based on historic cost or market, whichever is the lower, and few U.S. corporations adjust the accounts of their subsidiaries for price level changes. When the rate of inflation is low and approximates that in the United States, there is little distortion. However, when the rate of inflation is high, unadjusted local statements will have little meaning, due to the change in purchasing power of the currency. As a result, comparing past and present statements will be misleading, depreciation and amortization changes will bear no relation to the current value of the assets, and overall, the matching of revenues and expenses will be distorted. Statements translated into dollars will only approximate the true current purchasing power position to the extent that devaluation has kept pace with inflation over the relevant time period, and prices of the tangible assets have kept pace with the general increase in prices.

The "net asset" method of translation coupled with an adjustment of the local currency accounts for the effect of *general* price level changes does allow a separation of the effects of inflation and devaluation from the operating results. However, the choice of an appropriate price index may present a problem. Furthermore, where devaluation has not kept up with inflation, the "adjusted net asset" method may also understate the funds available for actual *conversion* into dollars, based on unadjusted local currency profits.

Finally, the various economic factors, taken together with the local political situation, will largely determine the risk and uncertainty which the company perceives in doing business in the particular country. When profit or retrun on investment goals are set for different subsidiaries, an attempt should be made to adjust the goals for the differences in risk between countries, even if this can only be done by using local rates of return in comparable businesses, or local interest rates.[5]

3. Accounting and Business Practice

Accounting practices, either set professionally or required by the government, differ from country to country, particularly in the determination of net income. The management control system is usually built around the financial and cost accounting systems, and it can be difficult, costly, and a significant burden on local management to demand uniformity and standardization according to American practice. The standardization of accounts for external reporting and tax purposes can be done by the corporate headquarters, since there is little learning benefit from this lengthy procedure for local management. However, for management reporting purposes some attempt should be made at the subsidiary level to eliminate the effects of particular local accounting practices which are not followed in other subsidiaries.

In a decentralized domestic company, a subsidiary or division general manager has usually come up through the ranks and has had ample opportunity to learn the company "philosophy" or "way of doing things". This is seldom the case with a foreign national who is general manager of a foreign subsidiary, and a heavy burden is placed on the control system as a major means of communication.

In many countries, there is a negative attitude towards numbers and the use of impersonal control reports as a means of evaluating performance. Moreover, the control system is rarely as sophisticated and formal as in U.S. companies,[6] and the ratio of staff to line personnel is usually lower than in the United States, resulting in less attention to costing, general accounting, and quantitative reporting. A frequent solution has been to use an American accountant, but he often becomes the object of suspicion as a "Trojan Horse" in the operation. A more successful approach may be to involve the local manager in the design of his own control system, after having been exposed to the domestic system and its objectives. As international companies attempt to use more local management in their foreign operations, adequate training in the use of the control system, and the ideas upon which it is based, becomes essential.

4. Government Regulation

A multinational business not only has to operate in differing economic environments, but also in differing legal and regulatory frameworks. Taxation considerations have in the past had a major impact on not only the legal structure of a corporation's international operation, but also on location of operations, licensing and royalty arrangements, transfer pricing, the allocation of production, and remission or transfer of capital. To the extent that decisions affecting profitability are made for tax reasons and are outside the control of the subsidiary management, their effect should be separated out in the reporting and evaluation of performance.

Transfer prices may frequently be set to minimize the corporate tax liability or customs duties, or to control prices in the local market. Within the multinational corporation they are seldom set by negotiation between divisions with the option of using outside suppliers. In order to optimize the return to the company as a whole, central administration of transfer prices is usually resorted to. Whatever conditions are imposed by headquarters, allowance should be made in the management control system to avoid conflict with local managers, and to establish a sound basis for evaluating their performance.

There are many other forms of government regulation which limit the local manager's actions and which vary from country to country. These include exchange and capital controls, price control, building and labor regulations. The problem which this diversity of regulations poses for the management control system is that no two countries are alike, making it impossible to apply a single standard of performance to all subsidiaries without some form of compensating adjustment. Each manager must be evaluated on his ability to achieve the goals set for his particular subsidiary through a process of budgetary review, and the degree of decentralization must inevitably be greater than in a more homogeneous group of purely domestic operations.

In many instances, liaison and cooperation with government officials becomes a vital function of the subsidiary general manager, and the effectiveness with which he carries out this role is certainly not amenable to traditional methods of reporting and control. Nevertheless, some attempt at evaluating the relevance and effectiveness of government-company relations would be useful.

5. Socio-Cultural Differences

The concept of delegation of authority and responsibility developed in the American decentralized organisation is very different from the traditional hierarchial structure found in many foreign countries, where all authority and decision making is vested in the head of the organization. The consultative, group-concensus type of decision making, is equally different from the more usual authoritarian patterns overseas. In a culture such as the Latin one, in which the dominant time orientation is towards the past, the very concept of planning may be foreign and incomprehensible. Furthermore, the profit motive itself, with its related competitive outlook and desire for growth and achievement, are values which may not be established or have similar motivational effects in many foreign environments.

However well designed in a technical sense, the management control system thus tends to be a particularly "uni-cultural" device. As more local nationals are appointed as subsidiary managers, effective communication between the foreign manager and the U.S. parent becomes increasingly difficult. Qualitative written and verbal reports are an important part of the control system, and they are likely to suffer in the attempts to communicate in a foreign language across social and cultural barriers.

The informal contacts between managers will also be seriously affected. Although these contacts are not a part of the formal control system, the informal system (or lack of it) must be recognized in the formal design. The informal contacts can help the control system to function effectively by spreading understanding of headquarters attitudes and expected norms of behaviour. It may prove extremely difficult, for example, to motivate a manager to pursue a policy of growth and to compete vigorously with rival companies, by merely focusing on profits and share of market in the control system. Informal advice and careful explanation which would be unnecessary for a U.S. manager, may be essential for the foreigner.

A possible means of obtaining mutual understanding is to ensure that the objectives of the management control system are carefully explained and related to local business practice in, for example, pricing, debt collection, or purchasing. Furthermore, the subsidiary manager should have some part in the design of the control system for his particular operation.

6. Organizational Structure and Corporate Strategy

The organizational structure of a multinational company is both more complex and qualitatively different from its purely domestic counterpart. This complexity arises chiefly because the structure must of necessity reflect the interaction of three dimensions: function, product, and also geography. Once foreign-based operations have been established in one or more of the company's products, these activities have to be related in some way to the domestic operations. Whether the primary form of organization is on a product or geographic basis, there still remains the problem of integrating the functional activities with the other dimension.

The resulting organization is a function of individual company experience and predisposition, technological requirements, product-market characteristica, and is also a response to the five major international factors discussed above in relation to the control system. Whatever system of organization is initially arrived at, however, stresses and conflicts are bound to exert pressure for change as the relative size of the international and domestic operations changes, and as top management attitudes towards the delegation of responsibility changes. These changes in organization and in the definition of responsibility centers will in turn require redesign and adaptation of the control system for the international operations, and ultimately for the company as a whole.

Coordination of activities becomes a problem when there are substantial transfers of materials and products between subsidiaries, or from domestic units to foreign subsidiaries and vice versa. Since the units are usually separately incorporated companies in different countries, it is usually not possible to resort to the usual domestic solution of combining the supplying and purchasing units under one profit or investment center. This solution would require complete separation of the management control and financial reporting systems, product transfer prices would still be required for the latter. A more practical solution would be to use standard transfer prices (such as lowest marginal cost source of supply plus a fixed fee) in the management control system, thus neutralizing the effect of any changes in the centrally administered transfer prices used for the financial reports, or in the source of supply stipulated by headquarters' management.

The strategy of a diversified multinational corporation will almost certainly include a number of different operating goals for its various subsidiaries, depending largely on the size and maturity of the particular subsidiary, its particular produt lines, and the economy in which it operates. Overall corporate objectives of growth, profitability, or return on investment, will therefore not be meaningful operating goals for an individual subsidiary, and the planning and control system must allow for evaluation of performance with reference to more detailed sub-objectives.

Within the organization, the job of the corporate controller is made more difficult by geographic dispersion and a multiplicity of accounting practices. His is a staff or service function, with responsibility for training and developing personnel in his functional area, assisting and advising the operating division managers and top executives on planning and control problems and procedures, and for carrying out such planning and control work for the company as a whole as can best be done at the corporate level. These activities usually include economic forecasting, preparation of the overall corporate budget, and supervising the review of individual subsidiary budgets.

Although responsible for the design and operation of the company's control system, the controller is designing the system for line management, and their needs are the determining factor. Consequently, line managers at the subsidiary and corporate levels should play a major part in designing the system by which they will be evaluated. Subsidiary controllers should only be responsible to their own general managers, and not to the corporate controller.

III. Implications for the Design of a Management Control System in a Multinational Corporation

As we can see from the above analysis, many problem areas have been outlined, but only a few solutions suggested. This is because there are many variables involved in the control process and the solution to a particular problem depends largely on the specific situation. Moreover, very little research has been done in the area of management control of foreign operations, other than discussion of price-level and exchange rate problems in financial accounting. As yet, there is no concensus on good and bad practice or even on the relevant variables.

However, a few of the more important conclusions and propositions drawn from the above analysis and from research in a number of multinational companies, can be summarized as follows:

1. The methods used to measure and evaluate the performance of the subsidiaries should be such as to encourage the local manager to balance shortrun and longrun implications of his actions, and to take actions appropriate to the particular economic and competitive environment which will be consistent with achieving the goals set for his operation.
2. Since, within the diversified multinational company, operational goals are likely to vary with the product and the country of operation, a standardized company-wide set of objectives is *not* feasible. However, a standardized control system and set of measures of performance is feasible if it is realized that not all of the measures will be relevant in each case and standards of performance must be set for each subsidiary. The management control system should be flexible so as to allow the factors which headquarters attempts to control to vary with the economic environment, and the maturity of the subsidiary and the experience of the local manager.
3. The international management control system is usually built around the financial reports which follow accepted U.S. accounting practice. It would be more useful, particularly for subsidiaries in inflating economies and unstable exchange rates, for the control system to be independently designed to bring out the influence of inflation and devaluation, while also ensuring an appraisal of the other critical factors relating to the particular operation. Given the objective of maximizing dollar

earnings of the company for earnings per share reporting, the "net asset" method of translation adjusted for price level changes is the most informative where there is inflation greater than the accompanying devaluation. In those cases where amount of the devaluation exceeds the rate of inflation, the "financial asset" method of translation will maximize dollar earnings. Whatever method is chosen, however, translation of local results should be done by the local company, rather than by the corporate headquarters, in order to make clear the objectives of the parent company.

4. The diverse economic conditions involved in operating in many countries makes it desirable that those economic factors crucial to the success of the particular subsidiary be incorporated in the formal management reporting system so as to improve planning and allow more realistic evaluation of performance.
5. Overall corporate objectives of growth, profit, or return on investment, should be adjusted for the risk and individual circumstances of each subsidiary in order to be meaningful as operational goals.
6. The subsidiary manager should be held responsible only for those factors over which he has separately control or influence. It is therefore desirable to account separetely for the effect of headquarters' determined transfer prices, allocated expenses, and taxation. This can be done, for example, by using standard transfer prices irrespective of the actual figures used in the financial reports.
7. The most effective means of obtaining mutual understanding between subsidiary managers and corporate headquarters regarding the use and purposes of the management control system, is to involve the subsidiary managers in the design of the reporting system for their particular operation.
8. Evaluation of subsidiary performance should, amongst other relevant measures, include a measure of the total subsidiary contribution in dollars to the parent, including such items as administration fees and purchases as well as earnings and dividends remitted. (See Table IV)

Table IV
MEASURING A SUBSIDIARY'S CONTRIBUTION TO THE PARENT CORPORATION

SUBSIDIARY CONTRIBUTION =

NET INCOME:

BEFORE:

— intra-corporate charges (royalties, administration fees, etc.).
— intra-corporate payments for goods, services, etc. at prices above U.S. cost or above the price charged to the outside market.
headquarters' indirect expense allocations.

AFTER:

– local taxes
price level adjustments where inflation is greater than, say, 5 per cent. per annum.
— a capital charge on net assets, varied by the parent to reflect an expected return on investment.
— translation into U.S. Dollars.

References

[1] Anthony, Robert N., *Planning and Control Systems: A Framework for Analysis.* Division of Research, Harvard Business School, Boston, 1965.
[2] Ibid., p. 17.
[3] This method assumes that only the current assets of a business change their dollar value with a change in exchange rate. The "financial asset" method assumes that only the financial or monetary assets change their dollar value, and similar reasoning is used for the "net asset" method. See: Hepworth, Samuel R., *Reporting Foreign Operations,* University of Michigan, Ann Arbor, 1956; and National Association of Accountants, *Management Accounting Problems in Foreign Operations,* N.A.A. Research Report 36, New York, 1960.
[4] Kindelberger, C.P., *Foreign Trade and the National Economy,* Yale University Press, 1962, p. 19.
[5] See Pryor, M.H., Jr., "Planning a World-Wide Business", *Harvard Business Review,* March-April 1965.
[6] Granick, David, *The European Executive,* Garden City, N.Y., Doubleday, 1962, pp. 251–3.