Chapter 20

International Control

Control is a fundamental task of management and its main task is to provide adequate information to decision makers at different levels of the company. This Chapter introduces the functions of international control, discusses the particularities of control in a MNC and describes several control instruments.

Introduction

Control is a fundamental task of management. It involves developing plans for a company, including budgets, monitoring the actual results and deciding on corrective actions in case the actual results differ from the planned results (Rugman/Collinson 2009, p. 444; Mellahi/Frynas/Finlay 2005, p. 347).

Control Process

The typical *control process* for a MNC subsidiary consists of three steps: First, HQ and the subsidiary jointly plan the objectives for the subsidiary for the next year. The influence of the subsidiary management in this process differs strongly between different MNCs. Second, throughout the year, the HQ monitors the performance of the subsidiary against the set objectives. Third, if the subsidiary fails to achieve its objectives, the HQ intervenes to learn why the problems occurred and reacts accordingly when necessary (Hill 2009, p. 666). In addition, on the level of corporate controlling, the plans and budget proposals of the diverse subsidiaries or divisions have to be *consolidated* in an overall plan and budget.

Defining Performance Simensions

More concretely, the first stage of the control process involves defining the performance dimensions. "*What you measure is what you get*" and, thus, the selection of performance indicators and the specific targets give a *sense of direction* and clarity of purpose to managers and employees at the different levels of the MNC and it serves to *align their activities* with the corporate strategy. It also exerts a *motivational influence*. The objectives for the subsidiary should be challenging but realistic (Merchant/Stede 2007; Boddy 2008, p. 640).

Traditionally, the most important criterion for evaluating the performance of a foreign subsidiary is the subsidiary's actual *profits* compared with budgeted profits. Other commonly used criteria include the subsidiary's actual *sales* (compared with the objectives) and its *return on investment* (ROI) (Hill 2009, p. 666).

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Effectiveness and Efficiency

More generally, controls can take many forms. A major distinction is between measures for effectiveness and for efficiency:

- *Effectiveness* is a measure of how well the outcome of an activity relates to the objectives. For example, sales, profits, the number of customers or of produced units could be measures of the effectiveness of a subsidiary unit. Effectiveness reflects "*doing the right things*".
- *Efficiency* is a measure of output divided by the input needed to produce the output. For example, sales per salesperson or produced units per machine hour are efficiency measures. Efficiency means "*doing things right*".

Objective and Subjective Measures

Some aspects of performance can be measured *objectively* (e.g. sales or ROI) while other performance indicators which might be equally important are more depending on *subjective evaluation* (e.g. innovativeness, company reputation, service quality) (Boddy 2008, p. 601). However, some level of quantification is necessary to compare actual results with pre-set standards.

Principal-Agent Problem

If one considers the HQ-subsidiary relationship from a principal-agent perspective (see Chapter 8), with the subsidiary acting on behalf of the HQ, then a major problem lies in the *information asymmetry* since the subsidiary (the agent) usually knows substantially more about its activities and its external environment than the HQ (the principal). From this perspective, it is the task of controlling to reduce this information asymmetry without causing information overload at the HQ. Thus, providing the right amount of necessary information is crucial.

Controlling as Staff Function

It has to be noted that the controllership function usually is a staff function. Controlling assists management in making decisions by providing adequate information. Thus, the controller delivers information and monitors performance but the use of this information remains the responsibility of line management (Merchand/Stede 2007). As a consequence, establishing and running a system to collect and provide information regularly, i.e. an *information and control system*, is part of the controlling task (Boddy 2008, p. 22).

Particularities of International Control

Considering the requirements for controlling a MNC, a set of heterogeneous factors, with regard to the external environment as well as to the internal relationship between subsidiary and headquarters, enhances the quantitative and qualitative challenges. Some measures are *uniform* across the MNC while others are *unique* to a certain situation or country. A number of particularities of international control are given (Zentes/Swoboda/Morschett 2004, pp. 802-806).

In a MNC, usually a *greater number of "control objects"* (e.g. divisions, countries, subsidiaries) has to be considered. In addition, these are usually characterised by a greater degree of *heterogeneity* than in a purely domestic context. Furthermore, the separate organisational units are interdependent, e.g. due to intra-company product flows. Fluctuations in *currency exchange rates* may cause substantial distortions in the comparison between subsidiaries and in the performance measurement. For example, the US subsidiary of a French MNC may fail to achieve its profit goals in Euro, not because of performance problems but merely because of a decline in the value of the US Dollar against the Euro (Hill 2009, p. 666). Due to different currencies, the control of cross-border transactions (including internal product flows) is also more complex. The *comparability* of data is not guaranteed. Different subsidiaries operate in different external environments, thus, comparing profits or ROI may not be an adequate measure to compare the performance of the subsidiary's management (Hill 2009, p. 669).

Curreny Exchange Rates

Different *legal systems, taxation systems and accounting practices* have long required the compliance of MNCs with heterogeneous reporting standards for their external financial reporting. While external financial reporting and internal control are two separate systems with different objectives and purposes, they are usually based on the same databases. Since IFRS (International Financial Reporting Standards) are now introduced as a legal standard in many countries (Boddy 2008, p. 646), a convergence of internal control is likely. International control concerns people from different cultural backgrounds, and *cultural differences* will affect how people respond to control systems (Boddy 2008, p. 622). Problems and misunderstandings between the HQ in one country and a subsidiary in a foreign country are more likely. Cultural differences have an impact, e.g., on the expected and accepted time horizon for planning and reporting, on the use of quantitative or qualitative performance measures, or on the degree of precision and detail in planning and monitoring.

Different Accounting Practices

Gathering *information* in the international context is *more difficult and more costly*; in addition, the information is often *more uncertain*. External data for foreign markets, in particular in less developed countries, might not be easily available. The resulting information advantage of the local management might be exploited to manipulate information which obviously limits its reliability. It also increases the problems of performance measurement (which is a type of agency problem). Finally, as has been pointed out in Chapters 1–3 of this book, the tasks and roles of subsidiaries in different countries vary and also other characteristics like the age or the value-added activities (manufacturing plants, sales subsidiaries, etc.). This has to be considered when measuring its performance.

Gathering External Data

Currency Issues

MNCs have subsidiaries in different countries and usually do business in different currency areas. As a consequence, MNCs are usually exposed to three kinds of exchange risks (Rugman/Collinson 2009, pp. 433-435):

Transaction Risk

- When specific contracts are denominated in a foreign currency, the MNC is confronted with *transaction risk*. In this risk, a financial loss may occur due to an unanticipated exchange rate change which affects already fixed future cash flows when exchanged in the home country currency. For example, accounts receivable in US-Dollars from the sale of a machine today that is being paid by the foreign customer in one year might not result in the planned Euro-value then. Instruments to reduce this risk exist (e.g. *futures* or *options*) but are costly.

Translation Risk

- The *translation risk*, or *accounting risk*, is the risk of losses on the MNC's balance sheet by value changes in foreign-currency assets and liabilities. For example, the plant and equipment of a Japanese subsidiary that is consolidated in the British MNCs' financial statement is subject to devaluation if the Yen is loosing value versus the British Pound.

Economic Risk

- *Economic risk* is the risk of unexpected changes of potential future cash flows from foreign operations that result from exchange rate changes. This can, e.g., be caused by changes in sales, prices or costs. As a recent example, the strong rise of the Euro against the US Dollar in 2007/2008 caused *Airbus* to issue profit warnings. It assumed that its products, which are mainly produced in the Euro-zone, will be less competitive in the future against *Boeing* since most plane purchases are contracted in US Dollars. A strategy of so-called "*natural hedging*" tries to reduce this risk by spreading costs over different currency areas. For example, *Mercedes* and *BMW* have built factories in the USA that allow shifting production output to or from a country as a response to a shift in exchange rates.

To avoid costly and unnecessary risk reducing mechanisms by separate subsidiaries that do not oversee the *MNCs' overall risk exposure* and can usually not evaluate the *net effects*, a certain level of centralisation of financial management of MNCs is required. As a general trend, MNCs today are using a centralised structure to manage currency and financial issues (Shenkar/Luo 2008, p. 402).

Particularities of Control in Multi-Level Organisations

MNCs are not only international, they are typically also multi-level organisations, composed at least of a headquarters, divisions (regional, product, or functional) and usually also country subsidiaries (see Chapter 9).

Heterogeneous Information Needs

"Quite simply, [...] information is produced because people need it. The reasons why they need it vary from one group of people to another" (Gowthorpe 2005, p. 73). It is evident that, in particular in a MNC, the needs of the different groups of people differ strongly – when comparing the information needs of corporate management, subsidiary management, a production manager or the marketing manager of a subsidiary. Since setting performance standards, monitoring them and providing information to the decision-makers in the organisation is the main task of controlling, the different decisions made at the different levels in the organisation and the related information requirements have to be regarded.

Decision and Information Requirements at Different Levels in a MNC

Table 20.1

Decision Type	Decisions	Information Requirements	Information
Strategic	Corporate Management		External
	• basic long-term strategic decisions for company • resource allocation to divisions • coordination of divisions (incl. selecting and appraising division management)	• opportunities/threats and strengths/ weaknesses info on coporate level • info across divisions (and performance) • long-term developments (highly aggregated)	
	Division Management		
	• basic targets for subsidiaries • mid-term planning • resource allocation to subsidiaries • coordination of subsidiaries (incl. selecting and appraising subsidiary management)	• targets from HQ • long-term, mid-term, rather speculative data • specific product and/or region related coordination and evaluation data • quantitative monetary info on division results	
	Subsidiary Management		
Operational	• development of country-specific strategies • coordination of operational issues in subsidiary	• targets from division management • operative data from internal accounting • only immediate info on external environment • supportive data from division or HQ	Internal

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 806.

As the overview in Table 20.1 indicates, the proportion of *strategic decisions* increases with the hierarchy level in the organisation, usually requiring more aggregated information about the *external environment* and rather *long-term, future-oriented* information. An attempt to capture fully the heterogeneity and cross-relationships within the MNC may even lead to information overload at the HQ which would reduce decision effectiveness. On the other side, at the level of subsidiary management, the preoccupation with *operational decisions* requires more *internal information*.

Level of Detail for Performance Targets

As another consequence of the multi-level organisation, the corporate management and subsequently the division managers have to decide on the level of detail with regard to the performance objectives for the subordinate

unit. This decision is related to the basic attitude concerning *centralisation* or *decentralisation* (Merchant/Stede 2007; Boddy 2008, p. 187):

- The superior hierarchy level can decide to set performance targets only on the level of *bottom-line figures*, i.e. rough outcome figures as ROI, etc. In this case, the subsidiary manager has the autonomy to decide *how* to achieve the desired results. These outcome figures are like a "compass" and give loose guidance – leading managers in the right direction but not commanding specific actions. Thus, this system allows for the flexibility to adopt to the specific host country or to unexpected changes.
- On the other hand, top management can set *unambiguous targets* about a *comprehensive set of performance indicators* which guarantees a tight control over the operational behaviour of the subsidiary. This systems acts like a "roadmap" which provides clear guidance to subsidiary managers as exactly how to achieve the specified objectives. The caveat is that superiors in the HQ might not fully understand the specific situation of the subsidiary and, thus, might not really know which subsidiary decisions are best suited to reach the objectives. It also severely limits the flexibility of the subsidiary management to respond to unexpected situations. The advantage of this approach is coherence in the subsidiary behaviour.

Subsidiary Participation in the Process

Considering the planning and budgeting process, the multi-level organisation also has to decide on the *level of participation* of the subsidiaries in this process (Zentes/Swoboda/Morschett 2004, pp. 813-815):

- In a *top-down planning process*, top management starts the planning process and in a cascading procedure, each subsequent management level uses this plan as an obligatory input and merely concretises the objectives for its organisational unit. The objective of plans at lower hierarchy levels (e.g. the subsidiary) is only to fulfil the preset objectives of the superordinate plans. The main advantage of this procedure is the strong coherence of the plans of the organisation; the main disadvantage is a negative impact on the motivation of subsidiaries, in particular if the preset performance objectives are not considered adequate by the subsidiary management.
- Pure *bottom-up processes* hardly exist in reality. Here, subsidiary management (or division management) would set their own performance targets and take decisions for their own organisational units. At the top-management level, plans would be merely acknowledged and maybe consolidated. The advantages of this procedure would be that subsidiary managers are highly motivated to reach the self-set objectives and that the targets are fully aligned to each local context.

Most Common Participation Process

- By far the most common procedure is an integrated *top-down-bottom-up process* that attempts to combine the advantages of both processes. Here, top management issues *guidelines* and rough performance objectives for all divisions/subsidiaries. Then, each subsidiary develops concrete plans and performance targets for its organisational unit, e.g. budgets for the coming year. These plans and budgets are proposed to the HQ. After consolidation and analysis, the HQ might request modifications which then are carried out by the subsidiary in new proposals. These steps might be repeated several times and for an annual budgeting process, the whole procedure may last about three to four months. Despite the time and effort, the procedure has many advantages. Since the process starts with HQ guidelines, coherence is guaranteed and at the same time, corporate priorities are clearly communicated to the subsidiaries. Interdependencies among organisational units are considered by the top-down approach. But simultaneously, the subsidiary is involved in the process which leads to better acceptance of the targets and, thus, commitment to achieve them.

Consolidation on the Corporate Level

In addition, in a multi-level organisation, *consolidation* of reports, financial indicators, financial statements, etc. becomes important. While the typical MNC comprises a parent company and a number of subsidiaries located in different countries and often organised as separate legal entities, most of which are wholly owned by the parent, economically, all the companies in the MNC are interdependent. Thus, the purpose of consolidation is to provide information about the group of companies in the MNC by excluding the transactions among the members of this group (i.e. eliminating sales figures resulting from intra-company product flows or netting out the amount of money owed between MNC units) (Hill 2009, p. 662).

Organisational Issues

As another concern in multi-level organisations, the organisational relation within the controlling function (which is usually a staff function) exerts a strong influence on the role and the main tasks of the controller (Merchant/Stede 2007). This can be described by using the example of a corporate controller and a divisional controller. The organisational challenge arises from the two main responsibilities of a *divisional controller*: On the one hand, he has a certain *support function for the division management*. On the other hand, the divisional controller has a *responsibility towards the corporate controller* to ensure that the internal control practices in the division conform to the corporate objectives and standards and that the information provided by the division to the HQ is accurate. He acts, thus, partly as a corporate guardian over the division activities.

Solid- and Dotted-Line Relationships

In each case, the division controller has to serve two different organisational units. Which of the two functions is dominant is largely dependent on the organisational attachment of the controller (Merchand/Stede 2007). If the divisional controller has a "*solid line*" relationship with the division management, reflecting that the division management has functional and hierarchical authority and the division controller a direct reporting responsibility to the division management, and only a "*dotted line*" relationship with the corporate controller (i.e. an indirect reporting responsibility) then the division support task prevails. Controllership function is in this case rather decentralised and the divisional controller perceived to be a "*division ally*" and a trusted supporter. If, however, the solid line is between the divisional controller and the corporate controller and the dotted line between the divisional controller and the division management, the direct reporting responsibility is giving emphasis on the internal and financial control responsibility. In this case of a centralised controllership function, the division controller is often seen as a "*corporate spy*", or at least more as a representative of HQ.

Performance Measurement

As has been shown before, profits, ROI, and other performance indicators of foreign subsidiaries are strongly influenced by the external environment in which they operate. Thus, using standardised quantitative criteria to assess the performance of subsidiary managers might not be adequate. However, this might make it necessary to separate the evaluation of the subsidiary itself from the evaluation of the subsidiary management (Hill 2009, pp. 668-669):

Evaluating Subsidiaries

- When *comparing subsidiaries*, it may be adequate to compare ROI, sales, profits, etc. Eventually, it is the task of the HQ to invest its resources in those countries that generate the highest returns. Whether the return of a foreign subsidiary is low due to strong competition, a negative exchange rate development or other influences are not of primary interest. Still, the MNC may want to reduce its investment in a low-performing country.

Evaluating Subsidiary Managers

- When evaluating the *performance of managers* of different subsidiaries, the economical, political, social conditions have to be considered. For example, the manager of a subsidiary that has grown by 3 % might have performed better than the manager of another subsidiary that has grown by 8 %, depending on the average market growth in two countries. Furthermore, it seems reasonable to evaluate the management on the basis of their results in local currency and after consideration of those financial effects which they cannot directly influence (e.g., interest rates, taxes, inflation, transfer prices, etc.).

Transfer Pricing

Intra-company Sales

One characteristic of most modern MNCs is substantial intra-company transactions, e.g. sales of components that are produced by one foreign subsidiary to a subsidiary in another country which uses those components to assemble a final product which might then be sold by another subsidiary in a third country. As already mentioned, about one third of world trade consists of those *intra-company sales*.

Influence of Transfer Prices

The price at which exchange of products or services or rights between different units in the MNC occurs is referred to as the *transfer price*. Obviously, the choice of the transfer price strongly affects the performance of the two subsidiaries that are engaged in the exchange. Using the *arm's length principle*, the price the buyer pays would be the market price under conditions of perfect competition. Thus, it would be openly negotiated between the foreign subsidiaries which would also require the free choice for the buyer to choose another, external supplier. This would also perfectly make use of market mechanisms as a coordination instrument for internal resource allocation. However, transfer prices are *not only a bilateral issue* between the subsidiaries, and *not a zero-sum game* since they also influence the overall profits of the MNC. For instance, raising the sales price of a certain component will raise the profit of the selling subsidiary on the expense of the buying subsidiary. If the selling subsidiary is located in a low-tax country, this will reduce the overall *worldwide tax liability* of the MNC. A similar influence is exerted by *custom tariffs*. Since these are often a percentage of the value of the goods, lowering transfer prices lowers the *import duties* to be paid. In addition, transfer prices might be set with regard to avoid *government restrictions on capital flows*. For example, transfer prices between a foreign subsidiary and the headquarters can be used as a hidden mechanism to repatriate profits from this subsidiary (Rugman/Collinson 2009, pp. 424-425; Hill 2009, pp. 685-686).

Restrictions on Fixing Transfer Prices

However, considering the strong impact of transfer prices, *government regulations* usually keep the range for manipulation in a rather tight frame. Also, the MNC's overall interest on setting certain transfer prices obviously has to be considered when *evaluating the subsidiary management* since this important profit determinant is in this case out of their direct responsibility. It also has to be noted that the flexibility is drastically reduced in the case of a *joint venture* (as buyer or seller) where each of the joint venture partners might have different strategic objectives linked to the transfer price.

Selected Control Instruments

On the strategic level, relatively broad and highly aggregated plans about missions, goals and general strategies are developed (Mellahi/Frynas/Finlay 2005, p. 347). On the operational level, short-term financial planning is the major concern of control, and operational optimisation, with a strong emphasis on quantitative data. The tactical level is the intermediate level between strategic and operational level. From strategic control to operational control, the level of detail and specificity increases while the planning and control period decreases. Control instruments can roughly be attributed to the three levels. *Operational control instruments* include short-term budgets, cost control, inventory control, break-even analysis, or contribution margin analysis and short-term budgets. *Tactical instruments* are, e.g., ABC analysis, industry analysis, benchmarking and financial ratio systems (like the Du-pont pyramid). Typical examples of rather *strategic control instruments* are portfolio analysis, scenario planning, balanced scorecard and shareholder value.

Budget

A budget is a plan, expressed in financial terms (or, more generally, in quantitative terms) which extends for a certain period (often one year) into the future (Gowthorpe 2005, p. 378).

Usually, in particular in complex organisations, a number of budgets is prepared, e.g. for sales, production, labour, etc. A reasonable *starting point* is frequently given by the sales budget. With this as input, the production budget can be prepared. This again is usually directly linked to a materials budget, a labour budget, etc. The outcome of the budget process then is a *full set of interrelated budgets* (Gowthorpe 2005, p. 387). Part of international control involves ensuring the coherence of these budgets.

Portfolio Analysis

It is a principal task of the MNC top management to develop a corporate strategy that *defines the businesses* in which the company should be active and, thus, to *structure the portfolio* of businesses. Closely related to this task, the MNC management has to ensure an *effective resource allocation* across business fields, countries and value-added functions. Portfolio models offer a framework that allows an overall assessment of the given portfolio of business units and to determine the desired composition of the future portfolio (see Grünig/Kühn 2006, pp. 165-193, with a detailed overview of such models).

Most portfolio models have in common that they position objects (mostly business units) in a two-dimensional space, i.e. a *matrix* that is created from two criteria. Usually, they also suggest *norm strategies* for the overall portfolio as well as for business units in a specific position in that portfolio. The main differences between the portfolio models are the selected dimensions:

Investment Optimisation Models

- Traditionally, the term "portfolio" origins in the *investment optimisation models*. Here, the portfolio dimensions (which can also be applied to business units or country subsidiaries if they are seen as investment objects which have to yield a certain return on investment) are *risk* and *return*, with the implication that diversification helps to reduce *overall* risk and that the optimal diversification depends on the correlation of risks of the diverse business units.

BCG Matrix

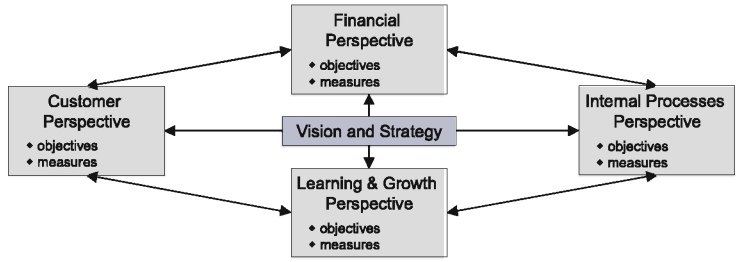
- In the well-known *Boston Consulting Group portfolio matrix*, the *relative market share* of the business unit and the *market growth rate* are used to group business units into categories such as *cash cows* (high market share but low growth) or *question marks* (low market share but high growth). It is assumed that, for example, the cash expenditure and the cash inflows depend on the two dimensions and, thus, a balance in the portfolio of cash-generating business units and cash-requiring (but high growth) business units should be given to ensure the long-term competitiveness of the company.

- Another often used portfolio matrix is the *General Electric matrix* which uses the *industry attractiveness* and the *competitive strength* of the business unit as dimensions.

Balanced Scorecard

The control instrument that has arguably attracted most attention in the last decade is the balanced scorecard (BSC) proposed by Kaplan and Norton in 1992. Basically, this is a specific, four-dimensional performance measurement system that comprises *financial objectives* as well as *non-financial measures* (see Figure 20.1). "The balanced scorecard translates an organization's mission and strategy into a comprehensive set of performance measures that provides the framework for a strategic measurement and management system [...] The BSC enables companies to track financial results while simultaneously monitoring progress in building the capabilities and acquiring the intangible assets they need for future growth" (Kaplan/Norton 1996, p. 2). More specific, the BSC is build on the assumption of leading and lagging indicators with financial indicators considered to be "lagging" and other indicators (like learning & growth) seen as "leading" indicators that are closer to the root of the long-term company success.

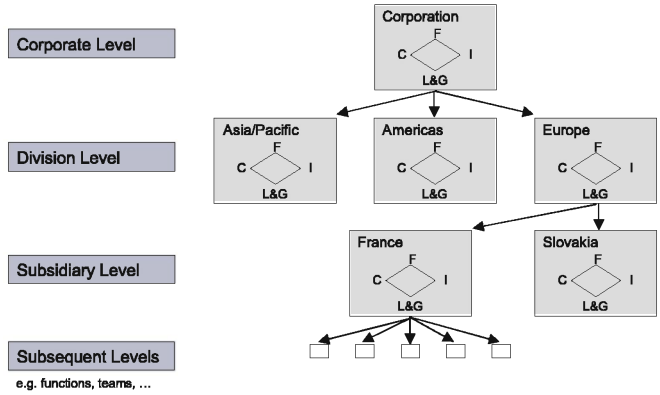
Figure 20.1 *The Balanced Scorecard*



Source: Kaplan/Norton 1996; Gowthorpe 2005, p. 542.

With regard to international control in a MNC, the BSC offers the opportunity to break down superordinate strategies and detailed performance measures on the corporate level into specific and clear objectives for subunits (see Figure 20.2).

Figure 20.2 *Implementing the Balanced Scorecard in Multi-Level Organisations*



Source: Adapted from Rieg/Gleich 2002, p. 697; Zentes/Swoboda/Morschett 2004, p. 830.

Thus, a rather detailed set of performance indicators which comprises financial and non-financial measures is targeted by each subunit, guaranteeing coherence in the organisation.

Shareholder Value

From the shareholder perspective, a major objective of management is to increase the value of the company for its owners. Thus, company decisions should be based on their expected influence on shareholder value. Translating this to MNC management, the performance of a subsidiary or investment project is measured in terms of its contribution to the value of the MNC (Zentes/Swoboda/Morschett 2004, pp. 839-844).

This dynamic investment perspective investigates expected future cash flows and is calculated, e.g., based on *discounted cash flow* (i.e., the net present value of future free cash flows). An example of value-based performance measurement is presented in the *Daimler* case study to this Chapter.

Economic Value Added (EVA)

One of the most frequently applied models of value management is the economic value added (EVA) developed by *Stern Stewart* (Stern/Shiely/Ross 2001). EVA is computed according to formula (1) (Dragun 2004, p. 162; Estrada 2005, p. 288):

(1) EVA = net operating profit (after taxes) - WACC x capital

Thus, the value added considers not only the profit of the company but also whether the profit is sufficient to compensate its capital providers appropriately. It is calculated as profit (using an adjusted profit measure) less the *cost of capital*, thus, as a kind of residual income over the required rate of return for the capital investment (which also considers the *opportunity costs* for the investor). A problem is to define the *weighted average cost of capital* (*WACC*) which is averaging across the costs of debt and the costs of equity capital. The costs of debt are simply the interest expenses required to serve the debt. But the cost of equity capital is more difficult to calculate because it depends on uncertain factors such as overall stock market risk, return expectations and the *risk-free rate of return* available to investors (Dragun 2004, p. 161). In particular in MNCs, the required rate of return that includes a *risk premium* can differ for investments in different countries or different investment projects that carry different risks. For each investment project in a subsidiary, if EVA is greater 0, this project creates shareholder value but if EVA is below 0, the project destroys shareholder value (Estrada 2005, p. 286). Across potential investment projects or subsidiaries, capital is to be invested in the one with the greatest expected EVA.

Risk Premium

EVA as Evaluation Criterion

Conclusion and Outlook

International control covers not only operational performance monitoring but in particular also strategic control which is mainly future oriented. In an international setting, the complexity of control enhances dramatically, due to, e.g., currency issues, different external environments and cross-border interdependencies. In the MNC, the multi-level structure adds to the complexity, resulting in highly heterogeneous information requirements at different organisational levels and units. A very comprehensive set of control instruments is available to handle this complexity. Their application depends not only on objective and rational decisions but also on subjective attitudes and corporate values.

Polycentric, Ethnocentric and Geocentric Orientation

The general "orientation" of the MNC will influence its response to the challenges for international control. With a *polycentric orientation*, the MNC will leave many decisions to the subsidiary, determine only rough objectives and merely control the output level, e.g. profits. With an *ethnocentric orientation*, the foreign operations are treated as extensions of domestic operations, leading to rather uniform planning and control systems and tight integration into the control system with rather detailed performance indicators and objectives which might neglect the particularities of each foreign country. The *geocentric solution* tries to handle control on a global basis with the adequate level of centralised decisions and uniform control instruments and performance objectives while regarding the heterogeneity of the subsidiaries (Rugman/Collinson 2009, pp. 422-423). This would include, for example, comparing performance of subsidiaries in a rather uniform way as an input for decisions on resource allocation but considering a more complex set of performance criteria for the evaluation of subsidiary managers.

As a general trend it can be observed that control is moving increasingly *from "looking back" to "looking forward"* to support management better (Nurdin 2009, p. 11). Related to this trend is the development that financial performance measures are increasingly supplemented with non-financial performance measures (like customer or employee satisfaction). The widespread application of the BSC clearly reflects this trend to monitor a comprehensive set of performance indicators.

Further Reading

KAPLAN, R.; NORTON, D. (1996): The Balanced Scorecard: Translating Strategy into Action, Boston, MA, McGraw-Hill.

MERCHANT, K.; STEDE, W. van der (2007): Management Control Systems: Performance Measurement, Evaluation and Incentives, Upper Saddle River, Prentice Hall.

Case Study: Daimler[1]

Profile, History, and Status Quo

Daimler is a globally leading producer of premium passenger cars and the largest manufacturer of commercial vehicles in the world. Headquartered in Stuttgart, *Daimler* generated revenues of about 78.9 billion EUR in 2009 and thus is one of the largest companies in Germany.

Origins of Daimler

The origins of *Daimler* date back to 1886 when Gottlieb Daimler (*Daimler-Motoren-Gesellschaft*) and Karl Benz (*Benz & Cie. Rheinische Gasmotorenfabrik*) made history by, independently from each other, developing the first internal combustion engine. In consequence of the dramatic situation of the German economy after the First World War, *Daimler-Benz* was formed in 1926 as a result of a merger between the two pioneering automobile companies *Daimler-Motoren-Gesellschaft and Benz & Cie. Rheinische Gasmotorenfabrik*. After recovering from the Second World War, *Daimler-Benz* positioned itself as an innovative manufacturer of high quality automobiles and evolved to one of the most successful car manufacturers in the world.

From Daimler-Benz to DaimlerChrysler

In 1998, *Daimler-Benz* and the US automobile company *Chrysler* announced plans to merge, with *Daimler-Benz* acquiring *Chrysler* for more than 35 billion USD in a stock swap. Operating as *DaimlerChrysler*, the newly formed corporation was led by dual headquarters and chairmen and it was agreed that the respective product brand identities would be operated separately. Moreover, in order to further strengthen its position in the automobile industry, *DaimlerChrysler* acquired a 34 % stake in *Mitsubishi Motors* in 2000. This move made *DaimlerChrysler* the third largest automaker in the world.

From DaimlerChrysler to Daimler

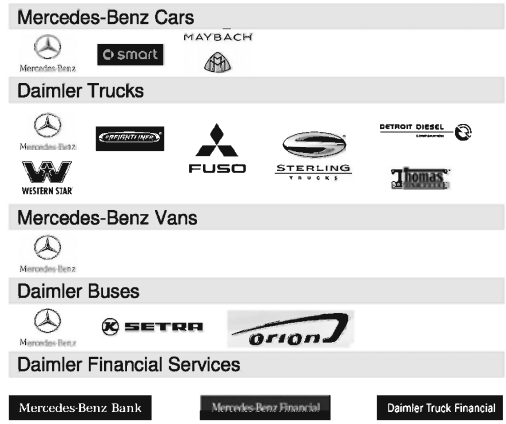
What started with the ambition to create the leading car manufacturer in the world, ended up in an economic disaster and one of the most prominent examples of value destruction in international management. Two vastly different corporate cultures, the lack of synergies, as well as performance and quality issues of *Chrysler*, forced *DaimlerChrysler* CEO Dieter Zetsche to terminate the collaboration between *Daimler* and *Chrysler*. With the transfer of a majority interest in *Chrysler* to *Cerberus*, a private equity company that specialises in restructuring heavily troubled companies, in 2007, a new chapter was opened in the company's history. The deal was accompanied by a change of name from *DaimlerChrysler* to *Daimler*.

1 Sources used for this case study include the web sites http://www.daimler.com, and various annual and interim reports, investor-relations presentations as well as sources explicitly cited sources.

Organisational Structure and Performance

Daimler operates a divisional structure that comprises five divisions. Figure 20.3 displays the divisions and the respective brands.

Figure 20.3 *Divisions and Brands of Daimler*



Source: Daimler 2010.

- The *Mercedes-Benz* Cars division comprises the brands Mercedes-*Benz, Maybach and smart. Mercedes Benz,* the most valuable premium car brand in the world, constitutes the core brand of the segment.
- The *Daimler Trucks* division develops and produces vehicles of the *Mercedes-Benz, Freightliner, Sterling, Western Star, Thomas Build Busses and Mitsubishi Fuso* brands in a global network. *Daimler Trucks* is the world's leading manufacturer of trucks.
- The product portfolio of the *Mercedes-Benz* Vans unit comprises the van model range of the *Mercedes-Benz* brand: *Vito and Viano, Sprinter, and Vario.*
- The *Daimler Buses* division supplies buses as well as bus chassis under different brands. *Daimler* is the market leader for buses above the eight tons mark and *Orion* is the world's leading producer of hybrid buses.
- *Daimler* Financial Services provides a range of leasing, financing, fleet management, and insurance products in close cooperation with the company's automotive brands. The *Mercedes Benz Bank* in Germany offers additional investment products and credit cards.

Table 20.2 reveals selected performance and financial key figures for the various divisions for the year 2007.

Selected Performance and Financial Key Figures for the Daimler Divisions 2009

Table 20.2

	Mercedes-Benz Cars	Daimler Trucks	Mercedes-Benz Vans	Daimler Buses	Daimler Financial Services
Revenues (in million EUR)	41,318	18,360	14,123	4,238	11,996
EBIT (in million EUR)	-500	-1,001	630	183	9
Unit Sales	1,093,905	259,328	165,576	32,482	-
Employees	93,572	70,699	15,226	17,188	6,800
Required Rate of Return on Net Assets (RONA)	12%	12%	12%	12%	13%
Net Assets (in million EUR)	11,373	6,720	1,728	1,221	4,671
Value Added (in million EUR)	-1,865	-1,808	-181	36	-599

Source: Daimler 2010, pp. 76-78.

International Controlling

Value Based Management

"The financial performance measures used at *Daimler* are oriented towards our investors' interest and expectations, and provide the basis for value based management"(Daimler 2010, p. 76). Key elements of value based management as performed by *Daimler* are (Malmi/Ikäheimo 2003, p. 251):

- aim to create shareholder value
- identify value drivers
- connect performance measurement, target setting and rewards to value creation or value drivers
- connect decision making and action planning, both strategic and operational, to value creation or value drivers.

Daimler's striving for value based management is in line with recent developments in controlling and accounting as value based management has attracted considerable interest among organisations across all industries (Malmi/Ikäheimo 2003, p. 235).

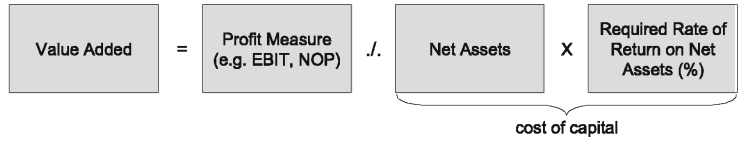
Value Based Performance Measurement at Daimler

Value Added

For purposes of performance measurement, *Daimler* differentiates between the group and the divisional level. The core performance measurement tool that is applied at both levels is *value added*. All management decisions at *Daimler*, like acquisitions or location decisions, are based upon this figure.

The value added indicates the extent to which the operational profit measure exceeds the cost of capital (see Figure 20.4). Hence, value added shows to what extent the group and/or its divisions achieve or exceed the minimum return requirements of the shareholders and creditors, thus creating additional value.

Figure 20.4 *Calculation of Value Added*



Source: Adapted from Daimler 2010, p. 76.

Elements of Value Added

The operational profit measure at divisional level of *Daimler* is EBIT (earnings before interest and taxes). EBIT is calculated before interest, income taxes and results from discontinued operations and thus reflects the profit and loss responsibility of the divisions. In contrast to the divisions, the operational profit measure at group level is net operating profit. Net operating profit includes the EBIT of the divisions as well as profit and loss effects the divisions are not considered responsible for, e.g., results from discontinued operations and income taxes. The cost of capital is comprised of two elements: net assets and the required return on net assets. Net assets represent the basis for the investors' required return. While performance measurement at the financial service segment is on an equity basis, the industrial divisions are in charge of all operational assets. Thus, all assets, liabilities, and provisions the industrial divisions are responsible for are allocated to them. Net assets at group level include the respective net assets of the industrial divisions and the equity of the financial service segment as well as net assets of discontinued operations, income taxes, and other reconciliation items the divisions are not responsible for. The required rate of return is derived from the minimum return that investors expect from their invested capital and comprises the cost of equity as well as the costs of debt and pension obligations of the industrial business. The cost of equity is calculated according to the capital asset pricing model (CAPM). Thus, the cost of equity is determined by the interest rate for long-term, risk-free securities (such as government bonds) plus a risk premium reflecting the specific risks of an investment in *Daimler* shares. The cost of debt is derived from the required rate of return for obligations entered into by the Group with external lenders. By

using the information provided in Table 20.2, Figure 20.5 illustrates the calculation of the value added for the *Mercedes-Benz* Cars division.

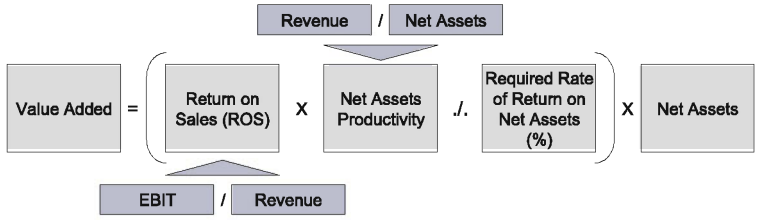
Value Added of the Mercedes-Benz Cars Division (in million EUR) in 2009

Figure 20.5

Alternatively the value added of the industrial divisions of *Daimler* can be calculated by using the *return on sales* (ROS) and *net assets productivity*. ROS is the ratio of EBIT and revenue while net assets productivity can be determined by dividing revenues with net assets (see Figure 20.6).

Determination of Value Added by using ROS and Net Asset Productivity

Figure 20.6

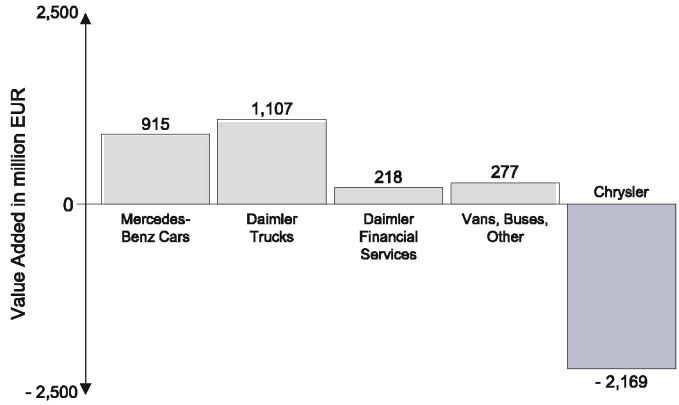


Source: Adapted from Daimler 2010, p. 76.

Value Based Decision Making at Daimler

The acquisition of *Chrysler* in 1998 and the disposal of *Chrysler* in 2007 were arguably two of the most important strategic moves in the history of the *Daimler* company. While the acquisition of *Chrysler* was based on a variety of reasons that range from synergy potentials to management compensation, the disposal of *Chrysler* was basically a value based decision. That becomes evident when comparing the value added of *Chrysler* in the fiscal year 2006 with the value added of the other divisions of the group. While all other divisions delivered a positive value added, *Chrysler* weakened the performance of the group with a value added of -2,169 million EUR (see Figure 20.7).

Figure 20.7 *Value Added of former DaimlerChrysler Divisions in 2006*



Chrysler more than offset the positive value added of the other divisions in 2006 and caused a negative value added for the whole group. The group's profit was therefore insufficient to cover the cost of capital employed. The reason for the poor performance of *Chrysler* was the difficult market and competitive situation in the USA. Hence, from a value based point of view, as *Chrysler* almost entirely absorbed the value contributions of the other divisions, selling *Chrysler* was doubtless a sound strategic move.

Reaction of Rating Agencies on Chrysler Deal

Immediately after the announcement that a majority interest in *Chrysler* would be transferred to *Cerberus* on 14 May 2007, Standard & Poor's upgraded its long term rating from BBB to BBB+ with a stable outlook. *Fitch* placed the BBB+ rating on a positive watch and upgraded *Daimler* from BBB+ to A- three days after the *Chrysler* transaction was closed. *Moody's* changed its outlook from negative to positive as well and finally upgraded the rating from BAA1 to A3 with a continuation of the positive outlook, providing *Daimler* with a higher flexibility in terms of financial management.

International Financial Management

The international financial management of *Daimler* is separated from other financial functions like reporting or accounting and rests on five pillars: capital structure management, cash management, liquidity management, management of market price risks, and the management of pension funds.

Capital Structure Management

Capital structure management is concerned with questions regarding the capitalisation of financial service, production, distribution, and regional holding companies. Apart from basic principles like cost-optimisation and

risk-optimisation, the equity levels of the group companies also depend on refinancing conditions in local banking markets as well as taxation legislation and restrictions on capital transactions in certain countries.

Cash Management

Cash management determines cash requirements and surpluses on a worldwide basis. *Daimler* undertakes remarkable efforts to limit the number of external bank transactions by internal assessment of cash requirements and surpluses. Subsequent cash concentration and cash-pooling procedures are performed accordingly.

Liquidity Management

Liquidity management is concerned with securing the company's ability to meet its payment obligations at any time. Therefore all cash flows from operating and financial activities are tracked in order to identify financial requirements. Besides operational liquidity, *Daimler* keeps additional liquidity through a pool of receivables from the financial service segment as well as a confirmed credit line. This additional liquidity is available on a short-term basis to settle urgent financial demands. Liquidity surpluses are invested in the money market to optimise returns.

Management of Pension Funds

The management of pension funds comprises the investment of pension assets to cover the corresponding obligations. Pension assets are held in separate pension funds and are therefore not deployable for general business purposes. Decisions on capital contributions worldwide are centralised in the pension committee. The funds are invested to different asset classes and constantly benchmarked to optimise fund allocation.

Management of Market Price Risks

As *Daimler* generates approximately 50 % of its revenues outside Western Europe, market price risks like fluctuations in interest rates and commodity prices and especially fluctuations in foreign exchange rates, constitute a remarkable threat for the financial performance and financial stability of the company.

Exchange Rate Risks

An exchange rate risk occurs when revenue is generated in a different currency than the related cost. For instance, the *Mercedes-Benz* Cars division is confronted with this situation. While huge parts of the revenues are generated in foreign currencies (especially USD), most of its production costs are incurred in EUR. The *Daimler Trucks* division, on the other hand, is exposed to this transaction risk as well, but to a lesser extent, because the division vastly benefits from a worldwide production network. Moreover, as many of *Daimler's* subsidiaries are located outside the EUR-zone, exchange rate risks also exist related to the net assets, revenues and expenses of these companies. Since the financial reporting currency of the company is EUR, the income and expenses of the subsidiaries have to be translated into EUR to fit into the financial reporting standards of the group.

Hedging Instruments

The company's overall exposure to exchange rate risks and other market price risks is determined on a continuous basis and hedging instruments are applied respectively. *Daimler* applies a total of four hedging instruments to minimise the impact of market price risks on the results of the group and the divisions: spot sales, outright forward, swaps and options. In contrast to the spot sale, that is a binding contract about the immediate purchase/sale of foreign currency to a fixed spot rate, the outright forward is a binding contract about the purchase/sale of foreign currency in the future at a fixed forward rate. A swap is a binding contract about the immediate and simultaneous exchange of foreign currency. An option grants the owner the right, not the duty, to purchase or sell currency at a specified exchange rate.

Summary and Outlook

The strategic goal of *Daimler* is to achieve sustainable profitable growth in all divisions and to increase the value of the group. However, realising profitable growth in a market that is characterised by overcapacities and thus extremely competitive necessitates a rigorous international controlling as well as a solid financial management. The disposal of *Chrysler* showed that, *Daimler* clearly connects decision making and action planning to value creation and has emphasised *Daimler's* aim to increase shareholder value as the most important factor of value based management.

Questions

1. The case study reveals the value added for the divisions. Calculate the value added for the whole group for 2009.
2. *Daimler* heavily emphasises the shareholder value concept. Compare and discuss the shareholder value approach with an alternative concept known as the "stakeholder approach".
3. In 2007, *Daimler* invested almost 3,500 million EUR to buy back its own shares. What was the rationale for this move?

Hints

1. See *Daimler's* annual report for 2009
2. See Argenti 1997 and Campbell 1997.
3. See Mitchell, Dharmawan and Clarke 2001 for a general discussion of buy-back programmes.