Chapter 23

International Control

Control is a fundamental management task, with the primary aim of providing adequate information to decision makers at different levels of the company. This Chapter introduces the functions of international control, discusses the particularities of control within an MNC and describes several control concepts, methods and instruments.

Introduction

Control is a fundamental management task. It involves developing plans for a company, including budgets, monitoring the results and deciding on corrective actions in case the actual results differ from the planned results (Rugman/Collinson 2012, p. 524; Boddy 2014, p. 22).

Control Process

The typical *control process* for an MNC subsidiary consists of three steps: First, HQ and the subsidiary jointly plan the subsidiary's objectives for the coming year. The influence the subsidiary management has in this process differs strongly between different MNCs. Second, throughout the year, the HQ monitors the subsidiary's performance 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 2013, p. 648). In addition, at the level of corporate controlling, the plans and budget proposals of diverse subsidiaries or divisions have to be *consolidated* into an overall plan and budget.

Defining Performance Dimensions

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 specific targets give a *sense of direction* and clarity of purpose to managers and employees at the different levels of the MNC. It also serves to *align their activities* with the corporate strategy and exerts a *motivational influence*. The objectives for the subsidiary should be challenging but realistic (Merchant/Stede 2012, p. 33; Boddy 2014, p. 595).

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 2013, p. 648).

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Effectiveness and Efficiency

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

- *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, depend more on *subjective evaluation* (e.g. innovativeness, company reputation, service quality) (Boddy 2014, p. 595). However, some level of quantification is necessary to compare actual results with pre-set standards.

Principal-Agent Problem

Considering the HQ-subsidiary relationship from a principal-agent perspective (see Chapter 10), with the subsidiary acting on behalf of the HQ, *information asymmetry* is a major problem, since the subsidiary ("the agent") usually knows substantially more about its activities and its external environment than the HQ ("the principal"). The aim of controlling is 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 controllership is usually 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* (Gowthorpe 2011, pp. 412-414). 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 2014, p. 25).

Particularities of International Control

When controlling an MNC, a set of heterogeneous factors, both from the external environment and the internal relationship between subsidiary and headquarters, increases 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 below (Zentes/Swoboda/Morschett 2004, pp. 802-806).

Currency Exchange Rates

An MNC usually has to consider a *greater number of "control objects"* (e.g. divisions, countries, subsidiaries) than domestic companies. In addition, these are usually characterised by a greater degree of *heterogeneity* than in a purely domestic context. Furthermore, the separate organisational units are often 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 German 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. 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 2013, p. 651).

Different Accounting Practices

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*) have been introduced as a legal standard in many countries (Boddy 2014, p. 633; Gowthorpe 2011, pp. 161-162), 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 2014, p. 588). 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.

Gathering External Data

Gathering *information* in an 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 or emerging countries, might not be easily available. The resulting information advantage held by 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, along with other characteristics like age or value-added activities (manufacturing plants, sales subsidiaries, etc.). This has to be considered when measuring that subsidiary's *performance*.

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 2012, pp. 513-514):

Transaction Risk

- When specific contracts are denominated in a foreign currency, the MNC faces *transaction risk*. This is the risk that a financial loss occurs due to an unanticipated exchange rate change which affects 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 (e.g. *futures* or *options*) are costly.

Translation Risk

- *Translation risk*, or *accounting risk*, is the risk of losses on the MNC's balance sheet through 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 loses value versus the British Pound.

Economic Risk

- *Economic risk* is the risk of unexpected changes to potential future cash flows from foreign operations that result from exchange rate changes. This can be caused by changes in sales, prices or costs. In recent years the Swiss Franc's gain in value has led to major challenges for numerous companies, because the translation of falling currency values decreased revenues. For example, the falling value of currencies in the USA, Brazil and India gave *Schindler*, a Swiss escalator and elevator manufacturer, cause to issue its second consecutive profit warning in 2013. Competitors like the German *ThyssenKrupp*, the US *Otis* or the Finnish *Kone* were not affected by this problem to such an extent, so *Schindler's* competitive position was weakened.
  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 production to be shifted between countries 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 MNC's *overall risk exposure* and can usually not evaluate its *net effects*, a certain level of centralisation of financial management of MNCs is required. As a general trend, MNCs today use a centralised structure to manage currency and financial issues.

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 11).

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 2011, p. 14). It is evident that, particularly in an MNC, the needs of these different groups of people differ strongly, for example 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 considered.

Decision and Information Requirements at Different Levels in an MNC — **Table 23.1**

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, Table 23.1 suggests the proportion of *strategic decisions* increases with the hierarchy level in the organisation, usually requiring more aggregated information about the *external environment* and comparatively *long-term, future-oriented* information. An attempt to fully capture the heterogeneity and cross-relationships within the MNC can even lead to information overload at the HQ, which would reduce decision effectiveness.

At the level of subsidiary management, a preoccupation with *operational decisions* requires more *internal information*.

Level of Detail for Performance Targets

As another consequence of multi-level organisation, the corporate management and subsequently the division managers have to decide on the level of detail for the subordinate unit's performance objectives. This decision is related to the basic attitude toward *centralisation* or *decentralisation* (Merchant/Stede 2012, pp. 15, 309-312; Gowthorpe 2011, pp. 414-415; Boddy 2014, p. 180):

- The upper hierarchy level can decide to set performance targets only through *bottom-line figures*, i.e. rough outcome figures such 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 dictating specific actions. Thus, this system permits the flexibility to adapt 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 tight control over the subsidiary's operational behaviour. This systems acts like a "roadmap" which provides clear guidance to subsidiary managers on exactly how to achieve the specified objectives. The caveat is that superiors in the HQ might not fully understand the subsidiary's specific and thus might not really know which decisions are best suited to reaching the objectives. It also severely limits the subsidiary management's flexibility when responding to unexpected situations. The advantage of this approach is coherence in subsidiary behaviour.

Subsidiary Participation in the Process

The multi-level organisation also has to decide on subsidiaries' *level of participation* in the planning and budgeting process (Zentes/Swoboda/Morschett 2004, pp. 813-815; Merchant/Stede 2012, pp. 317-318; Amann/Petzold 2014, p. 143):

- In a *top-down planning process*, top management starts the planning process and, in a cascading fashion, 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 present objectives of the superordinate plans. The main advantage of this procedure is the strong coherence of the organisation's plans; the main disadvantage is a negative impact on the motivation of subsidiaries, particularly if the current performance objectives are not considered adequate by the subsidiary management.

- Pure *bottom-up process*es hardly exist in reality. Here, subsidiary management (or division management) set their own performance targets and take decisions for their own organisational units. At the top management level, plans are merely acknowledged and maybe consolidated. The advantages of this procedure are that subsidiary managers are highly motivated to reach their self-set objectives and 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 approaches. 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 are then carried out by the subsidiary in new proposals. These steps might be repeated several times; for an annual budgeting process, the whole procedure may last about three to four months. Despite the time and effort required, this procedure has many advantages. Since the process starts with HQ guidelines, coherence is guaranteed and corporate priorities are clearly communicated to the subsidiaries. Interdependencies among organisational units are considered by the top-down approach. But, the subsidiaries are also involved in the process which leads to better acceptance of the targets and subsequent commitment to achieving them.

Consolidation on the Corporate Level

In addition, in a multi-level organisation, the *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) (Pratt 2011, p. 140).

Organisational Issues

Another concern in multi-level organisations is that the organisational relation within the controlling function (which is usually a staff function) exerts a strong influence on the role and principal tasks of the controller (Merchant/Stede 2012, pp. 617-619). This can be explained by using the example of a corporate controller and a divisional controller. The organisational chal-

lenge arises from the two main responsibilities of a *divisional controller*: On the one hand, he provides 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 his division to HQ is accurate. He therefore acts 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 controller's organisational attachment (Merchant/Stede 2012, p. 620). 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 comparatively 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 focused on the internal and financial control responsibility. In the 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 already been shown, profits, ROI, and other performance indicators for 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 be inadequate. However, this might make it necessary to separate the evaluation of the subsidiary itself from the evaluation of the subsidiary management (Hill 2013, pp. 650-651):

Evaluating Subsidiaries

- When *comparing subsidiaries*, it may be sufficient to compare ROI, sales, profits, etc. Ultimately, it is the task of HQ to invest its resources in those countries that generate the highest returns. Whether the low returns of a foreign subsidiary are 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* from different subsidiaries, the economic, political and 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 the two countries. Furthermore, it is reasonable to evaluate the management on the basis of their results in the local currency and after considering 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 a third of world trade consists of these *intra-company sales.*

Influence of Transfer Prices

The price at which an exchange of products, services or rights between different units in the MNC occurs is referred to as the *transfer price*. Obviously, the choice of transfer price strongly affects the performance of the two subsidiaries 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 at 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 in order 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 2012, pp. 503-504; Hill 2013, pp. 660-662).

Restrictions on Fixing Transfer Prices

However, given the strong impact of transfer prices, *government regulations* usually keep tight restriction on the range for manipulation. Also, the MNC's overall interest in setting certain transfer prices obviously has to be considered when evaluating the subsidiary management, since this important profit determinant is outside their direct responsibility. It must also be noted that 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 concerning missions, goals and general strategies are developed (Merchant/Stede 2012, pp. 307-308). 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 the strategic and operational levels. 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* include ABC analysis, industry analysis, benchmarking and financial ratio systems (like the *Dupont pyramid*). Typical examples of *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 2011, p. 359).

Usually, particularly in complex organisations, a number of budgets are prepared, e.g. for sales, production, labour, etc. The sales budget usually provides a reasonable starting point. With this as input, the production budget can be prepared. This is likewise 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 2011, p. 362). Part of international control involves ensuring the coherence of these budgets.

Portfolio Analysis

One principal task of MNC top management is to develop a corporate strategy that defines the businesses in which the company should be active and to thereby 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 the determination of the desired composition of the future portfolio (see Grünig/Kühn 2011, pp. 161-187; Grünig/Morschett 2012, pp. 65-68 with a detailed overview of such models).

Most portfolio models position objects (mostly business units) in a two-dimensional space, i.e. a *matrix* 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 chosen dimensions:

Investment Optimisation Models

- Traditionally, the term "portfolio" has its origins in *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 across the diverse business units.

BCG Matrix

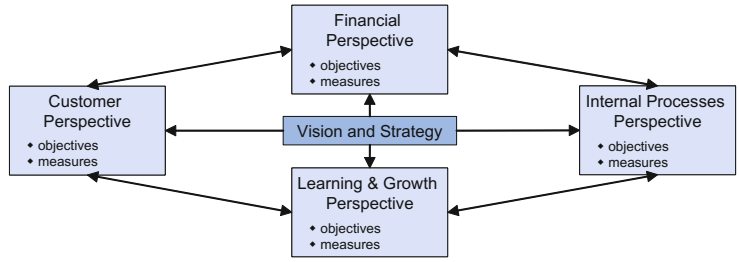
- In the well-known *Boston Consulting Group* portfolio matrix, the *relative market share* of the business unit and the *market growth rate* are used to group business units into categories such as *cash cows* (high market share but low growth) or *question marks* (low market share but high growth). It is assumed that cash expenditure and cash inflows depend on the two dimensions and, thus, a balance in the portfolio between cash-generating business units and cash-requiring (but high growth) business units should be chosen to ensure the long-term competitiveness of the company.
- Another commonly 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 the most attention in recent decades is the *balanced scorecard* (BSC) proposed by Kaplan and Norton (1996). This is a specific, four-dimensional performance measurement

system that comprises *financial objectives* as well as *non-financial measures* (see Figure 23.1). "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 specifically, the BSC is built 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 long-term company success.

Figure 23.1 *The Balanced Scorecard*

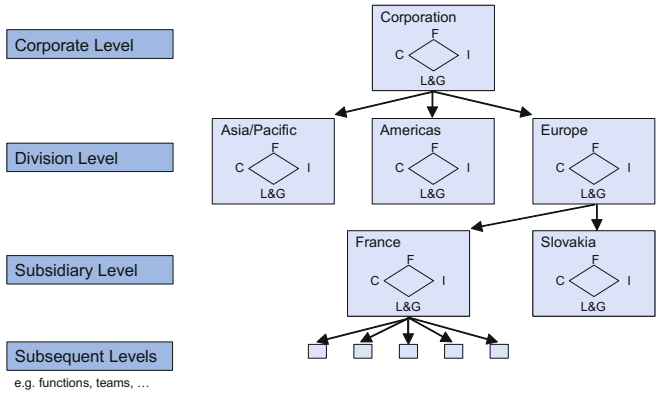


Source: Kaplan/Norton 1996, p. 9; Gowthorpe 2011, p. 425.

With regards to international control within an 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 23.2).

Implementing the Balanced Scorecard in Multi-Level Organisations

Figure 23.2



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

Thus, a detailed set of performance indicators comprising both financial and non-financial measures is produced for each subunit, guaranteeing coherence in the organisation.

Shareholder Value

From the shareholder perspective, one 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 *Henkel* 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 calculated according to formula (1) (Merchant/Stede 2012, pp. 427-428):

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

Cost of Equity Capital

Thus, EVA considers not only the company's profit but also whether this profit is sufficient to appropriately compensate its capital providers. It is calculated as profit (using an adjusted profit measure) minus 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). One problem is in defining the *weighted average cost of capital* (*WACC*), which is averaged 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 (Merchant/Stede 2012, pp. 418-419). Particularly for MNCs, a 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, this project creates shareholder value if EVA is greater than zero; but if EVA is below zero, the project destroys shareholder value (Estrada 2005, p. 286). Across potential investment projects or subsidiaries, capital should be invested in the one with the greatest expected EVA.

EVA as Evaluation Criterion

Conclusion and Outlook

International control covers not only operational performance monitoring but 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. Within an 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 comparatively uniform planning and control systems and tight integration into the control system, with 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 an adequate level of centralised decisions and uniform control instruments and performance objectives while considering the heterogeneity of subsidiaries

(Rugman/Collinson 2012, pp. 501-502). This would include, for example, comparing performance of subsidiaries in a generally 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 better support management (Nurdin 2009, p. 11). Related to this trend is the development that financial performance measures are increasingly being 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, McGraw-Hill.

MERCHANT, K.; STEDE, W. van der (2012): Management Control Systems: Performance Measurement, Evaluation and Incentives, 3rd ed., Harlow, Prentice Hall.

Case Study: Henkel*

Profile, History and Status Quo

Henkel is a German manufacturing company which operates worldwide with leading brands and technologies in the fields of detergents and adhesives. The *DAX*-listed company generated revenues of 16,355 million EUR and an adjusted operating profit of 2,516 million EUR in 2013.

The company has a strong presence in emerging countries. 44% of sales are generated there, while 34% of sales are attributed to Western Europe, 18% came from North America and a further 3% came from Japan, Australia and New Zealand. Besides the headquarters in Düsseldorf, Germany, there are seven regional centres in China, the UAE, Austria, Brazil, Mexico and the USA. Even the 18 major R&D sites are spread all over the world. Around 47,000 employees from more than 120 nations work in over 75 countries.

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

Consequently, 80% of employees work outside the home country. The company's products, which are produced at 164 sites in 54 countries, are available worldwide. These facts show that *Henkel* is one of the most internationally oriented companies in Germany.

The company dates back to 1876 when Fritz Henkel and his two partners Otto Dicker and Otto Scheffen founded *Henkel & Cie* in Aachen, Germany. At the same time, *Henkel*'s first brand-name product "*Universal-Waschmittel*" (Universal Detergent) appeared, and two years later the rollout of "*Bleich-Soda*" (Bleaching Soda) began. To take advantage of better transport and sales opportunities, *Henkel* relocated its headquarters to Düsseldorf, Germany. After Otto Dicker and Otto Scheffen left the company, Fritz Henkel was entered as the sole owner in the Commercial Register in 1879. In 1907, the laundry detergent *Persil* was launched, and is still available today. A few years later the first production subsidiary abroad was opened in Pratteln, Switzerland. In 1950, *Henkel* set up a new business sector by acquiring *TheraChemie* and its liquid hair colorant *Poly Color*. After a range of acquisitions and new market entries outside Europe, e.g. in South Africa and the USA, big steps in the company's history ensued in 1995 and 1997 when *Hans Schwarzkopf GmbH* and *Loctite Corp.* were obtained. Throughout its history, the company has been predominantly owned by descendants of Fritz Henkel.

Business Units

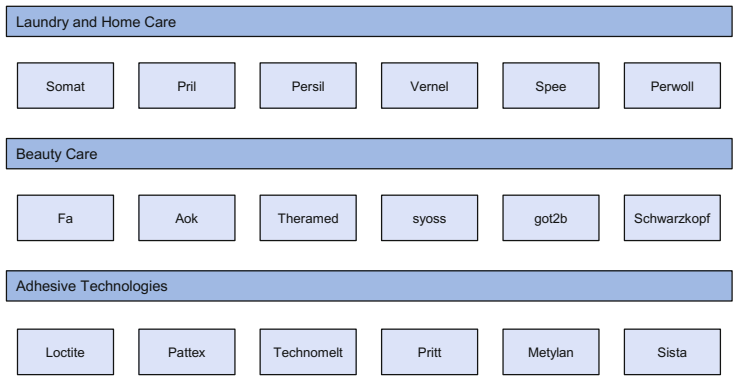
Henkel is structured into three business units: laundry and home care, beauty care and adhesive technologies. It is currently the world No. 1 adhesive producer according to its own account. *Henkel* has also reached globally leading market positions in consumer and industrial businesses e.g. with well-known brands like *Persil*, *Schwarzkopf* or *Loctite*.

Organisational Structure and Performance

Henkel remains true to its origins. As mentioned earlier, as well as the laundry and home care sector, beauty care and adhesive technologies form the *cornerstone* of the company. Figure 23.3 shows the business units and a range of respective brands.

Business Units and Selected Brands

Figure 23.3



Source: Henkel 2014.

- The laundry and home care business unit generated sales of 4,580 million EUR in 2013, 28% of total company sales. 70% came for laundry while 30% was attributed to home care. This unit comprises the top brands *Persil*, *Purex* and *Pril*, which together with another seven top brands make up about 85% of total laundry and home care sales. Strong competition in this field comes from huge players like *Procter&Gamble*, *Unilever* or *Reckitt Benckiser*. This business area is characterised by a high level of internationalisation. Large customers include German retail companies like *Edeka*, *Rewe* or *Metro* as well as French *Carrefour* and US *Walmart*.
- The beauty care sector is divided into three sub fields: hair care, body care and skin/oral. This business unit generated sales of 3,510 million EUR in 2013, 21% of total company sales. The strongest sector is hair care, which is responsible for two-thirds of the quoted sales. This is thanks to the strong brand *Schwarzkopf*, one of the world's leading suppliers of hair salon products thanks to its professional line. Other representative brands are *Syoss*, *Dial* and *got2b*. Major competitors in this field include *L'Oréal*, *Procter&Gamble*, *Unilever*, *Beiersdorf* and *KAO*.
- The adhesive technologies business unit supplies different target groups like end-consumers, craftsmen and industrial business under various brands. *Henkel* is the world market leader in adhesives, sealants and functional coatings. Sales of 8,117 million EUR were generated here in 2013, which equals 50% of company sales. Key competitors in the three customer groups of industry, consumers and craftsmen are *Bostik*, *Sika* and *BASF*.

Performance and financial key figures for the *Henkel* business units are presented in Table 23.2.

Table 23.2 *Selected Performance and Financial Key Figures for the Henkel Business Units (2013)*

	Laundry & Home Care	Beauty Care	Adhesive Technologies
Sales (in million EUR)	4,580	3,510	8,117
EBIT (in million EUR)	682	474	1,271
Adjusted Return on Sales (EBIT)	15.6%	15.0%	16.9%
Capital Employed (in million EUR)	2,321	2,007	6,752
Weighted Average Cost of Capital (WACC)	7.5%	7.5%	10.5%
Return on Capital Employed (ROCE)	29.4%	23.6%	18.8%
Economic Value Added (EVA; in million EUR)	507	323	562

Source: Henkel 2014.

International Control at Henkel

Value-Based Management

Henkel, especially its controlling, is influenced by *shareholder value*. This is particularly reflected by its values, where the pursuit of sustainable financial performance is noted. "We are a performance-driven company committed to growing the value of business and providing a competitive return to our shareholders" (Henkel 2011). Even *Henkel's corporate governance* is dedicated to achieving a long-term increase in shareholder value (Henkel 2014, p. 25). As a consequence, *Henkel* pursues the value-based management approach. "The objective of value-based management is to create, maintain, and deliver growth, and thereby deliver a long-term increase in shareholder value" (Häntsch/Huchzermeier 2013, p. 126). Combining traditional accounting-based measures of company performance with shareholder expectations is the main function of performance indicators (Rapp et al. 2010, p. 172). The key elements of value-based management are the creation of shareholder value, the identification of value drivers, the connection of performance measurement, target setting and rewards for value creation or value drivers as well as the connection of decision making and action planning (strategic and operational) to value creation or value drivers (Malmi/Ikäheimo 2003, p. 251).

Associated with the growing acceptance of the shareholder value principle, value-based management has attracted increasing interest among mangers, consultancy firms and the financial press (Rapp et al. 2010, p. 172).

Value-Based Performance Measurement at Henkel

"Performance Measurement is one of the critical factors how individuals in an organization behave" (Jensen/Meckling 1999, p. 8).

Performance Metrics

The key part of a value-based management system is a performance metric which is able to measure a company's value. Its function is to increase the informational content so that the management and its investors are supported in their strategic and operational decision-making. This leads to an alignment of managerial behaviour and shareholder targets. To reach this goal it is necessary for the performance metric to be consistently adopted across organisational functions and hierarchical levels. Traditionally used measures like earnings do not suit the requirements of value-based management, because they do not show the shareholder wealth which has been created. Non-financial performance measures do not meet the criteria of being available and comparable between different businesses.

To overcome these disadvantages it is necessary to use value-based metrics which draw on cash flows or earnings after the cost of equity. Frequently used *value-based performance measures* derived from cash flows include: discounted cash flow, shareholder value added and total business return. By using these measures, difficulties may arise if the value creation of a single period has to be measured. In this case *residual income metrics*, which refer to earnings instead of cash flow, are appropriate. The most common are: residual income, economic value added, economic profit and cash value added (Holler 2009, pp. 28-31).

Economic Value Added

Achieving a sustainable increase in shareholder value is of crucial importance for *Henkel*'s corporate management and control activities. Assessment of growth to date and appraisal of future plans are carried out on the basis of the economic value added (EVA), a central performance management parameter. Achieving sustainable EVA has a huge influence on all operating and strategic decisions like acquisitions or divestments. This concept helps with value-added decisions or the assessment of current or future profitable growth. An operation will be divested or discontinued if it yields consistently negative value contributions and future positive EVA cannot be expected.

EVA allows the measurement of additional financial value or net wealth that has been created by a company over a certain period. It is positive when the company's operating result outvalues the weighted average cost of capital. If the return on capital employed outvalues the cost of capital, then value is generated.

Elements of Economic Value Added

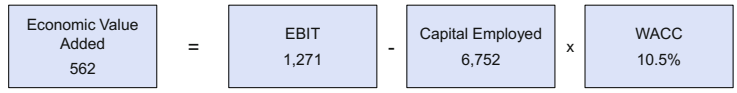
The operational profit measure at *Henkel* is *EBIT* (earnings before interest and taxes). This key figure allows the earning power of the operating business activities of a company to be assessed, which are independent of the company's financial structure. Thereby different entities can be compared, even if they are financed by varying levels of debt capital.

Capital employed describes the capital which has been invested in company assets and operations. Consequently this figure references the assets side of balance sheet. Its calculation is based on the total of operating assets, like goodwill at book value or inventories, of which operating liabilities are subtracted (resulting in net operating assets). After withdrawal of goodwill at book value and the addition of goodwill at cost the result is capital employed.

The costs of capital employed are calculated as a *weighted average cost of capital* (WACC). This value constitutes the minimum return of a company which is expected by its lenders for financing assets. Its calculation is based on the weighted average of the cost of debt and equity. The result is stated in percentage terms. Because of the dependence on the business sector involved, WACC rates differ for every business unit.

By using the information provided in Table 23.2, Figure 23.4 illustrates the calculation of the *economic value added* for *Henkel*'s business unit adhesive technologies.

Figure 23.4 *Economic Value Added of the Business Unit Adhesive Technologies in 2013 (in million EUR)*



Source: Adapted from Henkel 2014, p. 109.

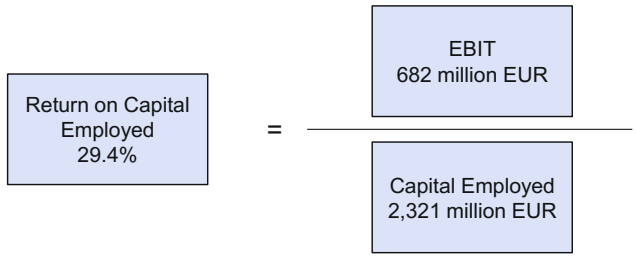
The business units vary in size, so comparisons among them is limited if only EVA is used. As a consequence, *Henkel* also applies another

measurement which refers to a return ratio, the *return on capital employed* (ROCE).

Figure 23.5 shows how *Henkel* calculates ROCE.

Calculation of Return on Capital Employed of the Laundry and Home Care Business Unit

Figure 23.5



Source: Adapted from Henkel 2014, p. 109.

Summary and Outlook

Henkel's strategic goal is to achieve sustainable profitable growth across all divisions and to increase the value of the group. By 2016, the company aims to reach ambitious targets like sales of 20 billion EUR, of which 10 billion EUR should be generated in emerging markets. Furthermore, a 10% average annual growth in earnings per share should be realised. To meet these objectives, rigorous international controlling is inevitable. *Henkel*'s overall aim of increasing shareholder value is the most important factor of value-based management.

Questions

1. *Henkel* heavily emphasises the shareholder value concept. Compare and discuss the shareholder value approach with the alternative concept known as the "stakeholder approach".
2. The shareholder value is established in *Henkel*'s vision and values. Which other areas are affected by this approach?
3. This case study highlights the usage of economic value added (EVA) as a measure in value-based management. Explain why traditional account-

ing measures like earnings or earnings growth are inappropriate value-based management measures.

4. Which other value-oriented approaches except EVA exist? List their advantages and disadvantages.

Hints

1. See *Henkel's* annual report for 2013.
2. See Holler 2009 as well as Merchant and Stede 2012.

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