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Control and Coordination of Functional Subsidiaries in Japanese Corporate Groups

(Executive Summary)

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The average number of subsidiaries owned by large listed Japanese corporations (measured by total assets) has more than doubled in 15 years, rising from around 45 in 1990 to 108 in 2005. This trend indicates that large Japanese firms are increasingly pursuing group formation or expansion strategies, even during the period of choose and focus when many of them underwent massive restructuring. We are also familiar with well-known names such as Sony, Hitachi, Panasonic, Toshiba and Fujitsu that each has hundreds of subsidiaries. Why do these firms pursue a group strategy and how do they manage their vast number of subsidiaries?

News coverage of large corporations sometimes leaves us with the impression that a corporation is a single entity in full control of all its activities. But in reality, subsidiaries make up an essential part of a corporate group, its routines and its core competencies. Seen in this light, the effective control and coordination of subsidiaries and the massive activities that they perform become a crucial management issue. Yet, despite its importance and relevance, especially as information asymmetries between the corporate head-office and the many layers of internal organizations and subsidiaries have become substantially greater in recent years, there appears to be very little empirical research on this topic.

This exploratory research therefore examines the questions of why do corporate groups exist? And how do corporations manage their subsidiaries? The objective of this paper is to bridge academic knowledge with practitioner's knowledge concerning the control and coordination of subsidiaries, and in doing so expand our knowledge of corporate group management. For the purpose of conducting an in-depth analysis, I have selected five corporate groups, namely, Hitachi, Panasonic, Mitsubishi Heavy Industry, Nihon Yusen and Japan Airlines. These cases represent fairly well large corporate groups in Japan, and provide an analytic generalization on how large corporations manage their subsidiaries.

Why do corporations establish subsidiaries and form corporate groups? This question can be analysed from two broad perspectives. Firstly, there is the perspective of management and business needs that range from using subsidiaries to develop new businesses and competencies to lowering transaction costs and labour costs, as previous empirical research and the case studies in this paper show. Secondly, though not unrelated to the first, there is the organizational perspective of using subsidiaries as a mode of governance instead of using the market or the hierarchical control within an organization. Academic theories such as the transaction cost theory, the property rights theory and incentive theories have posited that firms use subsidiaries to balance high external transaction costs and high internal costs that arise from production loss as a result of excessive control and management intervention.

The case studies revealed, however, that control and delegation do not necessarily have to be incompatible. In all of the cases, although the degree of delegation may depend on the activity that is concerned, the delegation of decision rights to subsidiaries is used alongside control by the parent company. For example, all the case study firms have control and coordination systems such as subsidiary counter-part head-office departments that coordinate activities with subsidiaries. Such control do not necessarily destroy incentives, on the contrary, they may enhance incentives as coordination eliminates uncertainties in human exchange. Instead of being restrictive, they enable subsidiaries to act freely as long as they do not violate agreements that have been made with the parent company. The case studies also revealed an emphasis on mutual agreement in coordination processes between the parent and the subsidiary. Hitachi's case, in which subsidiaries commit to certain performance levels and the parent company grants the subsidiaries autonomy contingent upon whether their promises and commitments have been kept, is a good example that shows how mutually agreed rules help players play more effectively.

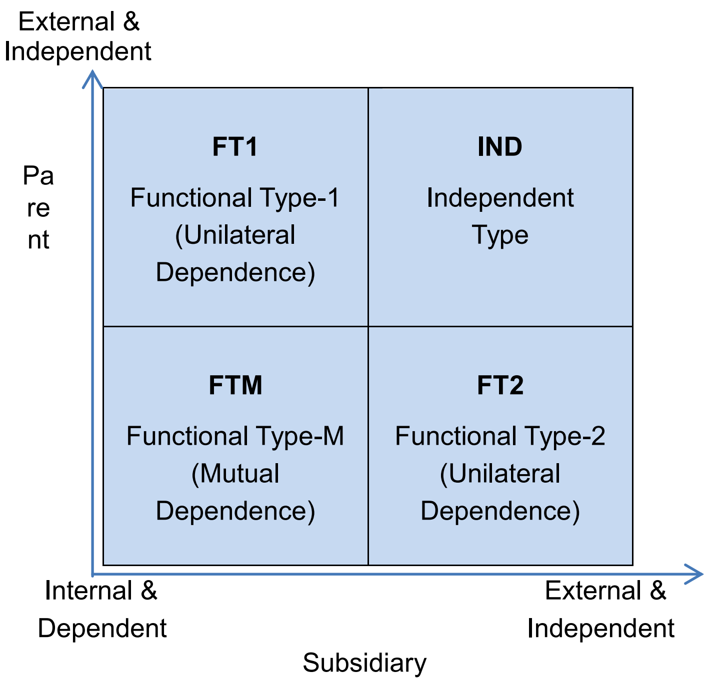
If then, balancing internal and external transaction costs, based on the assumption that control reduces productivity, is not necessarily the only economic rationale, what other rationale could there be? In this paper, I have posited another rationale, namely that using subsidiaries provide the firm with a wider range of options to choose from, and hence more flexibility to cope with multiple contingencies. Because subsidiaries are essentially intermediate organizations, the parent company can choose to use hierarchical control or market like transaction towards its subsidiary, contingent upon the situation at hand. One important implication here is that such contingencies mean at the same time that the role of subsidiaries can vary and change, and the degree of ownership and control too can vary and change.

This notion of wider options and the various possible roles a subsidiary could play, is related to the second research question of how are subsidiaries managed? The more I talked to companies during the case studies, the more I became acutely aware that there are many different types of subsidiaries in terms of the role they play. The implication here is that existing theories on subsidiary management, such as those concerning the delegation of decision rights, control and coordination, parent and subsidiary relationship, dual pressures and conflict, can be further expanded to study the situation within each type of subsidiary. In other words, investigating into different types of subsidiaries may open new avenues to the research of corporate groups.

In order to conduct a more in-depth analysis of subsidiaries, I constructed a four part classification based on the dependency relationship between the parent and the subsidiary. When I started conducting the case studies, I often found it confusing as to whether the role of the subsidiary that was described was the role as seen from the parent's perspective or from the subsidiary's perspective. For example, the parent may regard the subsidiary as one of many suppliers in the market, while the subsidiary may regard the parent as its sole client. Or the parent may depend on the subsidiary for inputs, while the subsidiary may depend not on the parent but on external clients as its major source of revenue. Seeing the role of a subsidiary from both the perspective of the parent and the subsidiary helps present a more complete picture of their relationship. This is useful, because different relationships produce different issues that require different ways of control and coordination as shown in the table below. It appears, however, that many firms are not aware of this disparity, and apply a rather uniform control on their different types of subsidiaries.

I therefore posit that aligning control and coordination systems to the different roles and relationships of subsidiaries is an important step towards establishing effective management of subsidiaries within a corporate group.

Figure 1. Four types of subsidiaries.



FT1: The subsidiary depends on the parent as its main trading counter-part and source of revenue.
The parent however sees the subsidiary as one may many trading partners in the market.

FTM: The subsidiary depends on the parent as its main trading counter-part and source of revenue.
The parent too depends mainly on the subsidiary for its production inputs or its specialized function.

FT2 The subsidiary has external trading clients in addition to the parent.
The parent however depends mainly on the subsidiary for its production inputs or its specialized functions.

IND: Both the subsidiary and the parent regard each other as one of many trading partners in the market.

Table 1. Linking Academic and Practitioner's Knowledge to Types of Subsidiaries

Academic and Practitioner's Knowledge	Types of Subsidiary
Transaction Cost Theory and Property Rights Approach Firms use subsidiaries to balance (1) high internal transaction costs that arise from excessive control that reduces productivity, and high external transaction costs that arise from using the market, and (2) control when there are high costs to allocating control rights exclusively to one party.	The control and coordination systems that the case study companies use do not necessarily entail trade-offs in productivity. Instead different types of subsidiaries entail different balance issues. 【FT1 Subsidiary】 Balance between favourable price and quality from either the subsidiary or market and utilization rate of the subsidiary. 【FTM Subsidiary】 Balance between firm specific production knowledge and the acquisition of knowledge and new technology which may not be accessible inside the corporate group. 【FT2 Subsidiary】 Balance internal pressure to invest in firm specific assets and external pressures to meet customer needs. A good balance may allow the parent company to leverage skills that the subsidiary has accumulated, as well as to benefit from economies of scale because of the subsidiary's expanded transaction volume. 【IND Type Subsidiary】 Balance between centrifugal and centripetal forces may be sought when the IND subsidiary is seen a crucial element in rebuilding the group's synergy.
Ex-post Lock-in of Group Boundary After a subsidiary has been established, other make or buy criteria such as utilization and profitability exist and matter. High switching costs and biases that justify using subsidiary over market may also prolong lock-in. Lock-in also implies the possibility of internal transaction costs outweighing external transaction costs. Investments in knowledge and high switching costs however imply the possibility of lock-in even when performances are sub-optimal.	The degree of lock-in may depend on the type of subsidiary. 【FT1 Subsidiary】 The parent could choose to use the market, but needs to consider utilization rate and profitability of the subsidiary. 【FTM Subsidiary】 Because of mutual dependence, lock-in will occur when there are high switching costs. This becomes problematic when locked-in routines are inefficient. 【FT2 Subsidiary】 The parent's dependence on the subsidiary forms a kind of lock-in, and this becomes problematic when there exits conflicting interests between the parent and the subsidiary, such as when the subsidiary, in focusing on external businesses, fails to invest in firm-specific skills.
Vertical and Horizontal Coordination: Managers and workers who have proper understanding of central management instructions, adjust those instructions using	The benefits of investing in the coordination and transfer of knowledge and information have to outweigh the costs of doing so. Very often, this depends on the type of subsidiary.

the local information that they perfectly observe. Benefits of coordination have to outweigh communication costs. Decentralization and Delegation of Decision Rights: Select appropriate level of decentralization based on the costs and benefits of delegation. Costs: Incentive cost, control loss and power abuse. Benefits: Access to local information, better and quicker decision-making. Coordination Systems: Corporate groups have multiple coordination systems that are used alongside decentralization and delegation systems.	【FT1 Subsidiary】 Little coordination is needed because the parent is not dependent on the subsidiary's output. 【FTM Subsidiary】 Because of mutual dependence, and especially when the subsidiary is integrated into the parent's production value chain, coordination systems will be used more widely to align incentives and knowledge. 【FT2 Subsidiary】 Because of dual pressures internally and externally, conflict may require more careful coordination. Managers who are seconded or transferred from the parent company may act at effective mediators. 【IND Type Subsidiary】 IND subsidiaries may have more autonomy because there is little dependency relationship. However delegation may be contingent upon performance of the subsidiary, which the parent company monitors.
Parent – Subsidiary Relationship: Dual pressures that could lead to conflict. Normative integration through socialization could reduce conflict. Agency problems may arise such that subsidiaries may pursue interests that diverge from the corporate group's goals. This can be reduced by monitoring and by designing incentive compatible contracts. Coordination systems facilitate the diffusion of knowledge between parent and subsidiary.	Indeed one chief purpose of classifying subsidiaries is to differentiate the different relationships that exist between the parent and its subsidiaries. 【FT1 Subsidiary】 The FT1's weak bargaining power deems it necessary for it to give in to demands made by the parent company. The subsidiary can however try to increase its bargaining power by shifting from FT1 to FT2 or IND. 【FTM Subsidiary】 Mutual dependence deems it necessary for the parent and subsidiary to coordinate regularly, and decision making may be more centralized. 【FT2 Subsidiary】 Agency problems may arise when external pressures are in conflict with internal pressures. 【IND Type Subsidiary】 IND subsidiaries may have more autonomy because there is little dependency relationship, but it is nonetheless monitored for its contribution to consolidated earnings of the corporate group.

Table 2. Difference in Coordination, Delegation and Relationship

Type	Coordination	Delegation	Relationship
FT1 Subsidiary depends on the parent but not vice versa	Assist in improving efficiency of function for example by transferring knowledge from parent.	Foster independent-ness and entrepreneurship.	Consider and balance both procurement input cost from subsidiary, and utilization and revenue of subsidiary.
FTM Subsidiary and parent depend on each other	Work closely to share tacit knowledge and to leverage capabilities of subsidiaries.	Because of dependence, major decisions may be relatively centralised. However, from an incentive perspective, it is also necessary to foster empowerment.	Be cautious of routine transactions. Benchmark market prices, and where it is deemed necessary, revise trading terms.
FT2 The parent depends on the subsidiary but the subsidiary depends on external clients	Control subsidiary as both profit and cost centre. Decide whether scarce resources should be used to develop firm specific competencies for the company or for external clients.	Increase control when there appears to be conflicting interests that could negatively affect the overall optimality of the corporate group.	Conflict may arise because of dual pressures from internal and external businesses. Try to mutually agree on scenario that maximizes group performance.
IND The parent and subsidiary are independent of each other and regard each other as one of many clients in the market.	Coordination may be little due to inexistence of dependency. Coordination may be more focused on overall optimality and part of the IND's function may be severed from the subsidiary's control and incorporated instead into the group's growth driver division.	Delegation contingent upon performance. Despite autonomy that is granted to the subsidiary, if it constitutes a major source of revenue to the group, then decision rights on major strategic issues may still rest on the parent company's top management.	Relationship may be closer if the IND is a core business of the group, and more distant if it is a non-core business. Thus IND can be further sub-divided into IND with synergy (which may require some level of central coordination) and IND without synergy (which may be allowed more autonomy).