Corporate Governance Options for the Local Subsidiaries of Multinational Enterprises*

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While the corporate governance literature generally focuses on the parent legal entity, many organisations are now multinational enterprises (MNEs) with subsidiaries that are most often legal entities in their host countries. Despite the strengthening of corporate governance regimes internationally, the boards of these subsidiaries are in many instances perfunctory. This paper examines the question of whether developments in corporate governance theory and practice can add value for the local subsidiaries of MNEs.

This paper provides a theoretical basis for evaluating governance models in MNEs. The paper commences with a review of the key concepts from the MNE and conglomerates literature with respect to core MNE strategies. The paper then discusses what the "governance roles" are that must be performed in MNE subsidiaries. We propose four governance frameworks for subsidiary corporations. These frameworks are: (1) Direct Control; (2) Dual Reporting; (3) Advisory Board; (4) Local Board. We consider the strengths and weaknesses of each model in relation to international strategy theory. We conclude with recommendations for the conditions under which the various models may be appropriate and practical guidelines for the utilisation of corporate governance theory to improve MNE performance.

Keywords: Corporate governance, multinational enterprises, subsidiary companies

Introduction

International business is dominated by both large and small multinational enterprises (MNEs), a trend that is set to continue as the pace of globalisation quickens. The corporate governance literature, however, often ignores the governance of MNE subsidiaries (MNSs). In most jurisdictions the MNE will have created a legal entity under that jurisdiction's laws to conduct the business of the MNS. In these jurisdictions this requires the appointment of local directors. Often the boards of directors in these subsidiaries have played a token role, fulfilling only the statutory duties required under the host country's legal system. They often play no real role in the governance of the subsidiary. This situation is changing, however, as MNEs recognise that subsidiary boards (SBs) can, in some circumstances, add value to the subsidiary (Gillies and Dickinson, 1999). Our objective in this paper is to provide a theoretical explanation and a series of research propositions as to the circumstances under which SBs operating in Anglo-American legal systems can add value.

To do so we first review the literature on governance and MNSs. We then consider the key governance roles that SBs may play. We review the MNE and conglomerates literature with respect to core MNE strategies and discuss these in relation to governance roles. We propose four governance frameworks for subsidiary corporations. These frameworks are: (1) Direct Control; (2) Dual Reporting; (3) Advisory Board; and (4) Local Board. We out-

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line the key features of each model and discuss their advantages and disadvantages. We further consider the strengths and weaknesses of each model in relation to international strategy theory.

We conclude with recommendations for the conditions under which the various models may be appropriate and practical guidelines for the utilisation of corporate governance theory to improve MNE performance. It should be noted that we restrict our discussion to unitary boards in countries with Anglo-American legal systems, as dual-board systems are beyond the scope of this paper. We also restrict our discussion to 100 per cent owned MNE subsidiaries.

Previous studies

While an emerging literature is developing on international differences in corporate governance, and there are arguments for and against an international convergence of practices (e.g. Aguilera and Jackson, 2003; Guillén, 2000; Rubach and Sebora, 1998), little has been written on the governance of MNE subsidiaries.

The paucity of literature on the governance of MNE subsidiaries is limited, perhaps due to the fact that a SB is just one of the coordination and control mechanisms an MNE can employ to manage an MNS (Martinez and Jarillo, 1989).

In an early study, Leksell and Lindgren (1982) examined the role of SBs of Swedish MNEs. They identified three main board roles, which they characterised as external roles (external relations; advice), internal roles (control and monitoring; coordination and integration; strategy formulation) and the legal role. They found that a major factor in determining the roles performed by a SB was the strategic importance of the subsidiary to the parent corporation – the parent gave more attention to the strategically important subsidiaries, e.g. by appointing more senior parent corporation managers to the SBs. However, the SBs did not, in general, play an active role in strategic planning.

Kriger and Rich (1987) examined how MNEs made use of SBs, finding that only a minority of MNEs used these boards proactively. The authors did note the value of SBs to their parent corporations where they were allowed to play an active governance role. In a survey of the SBs of MNEs located in North American, Japan and Europe, Kriger (1988) further investigated the role of SBs. His results showed that Japanese MNEs made more active use of SBs than their North American and European counterparts, who viewed SBs as only being useful in fulfilling statutory requirements. While Kriger found that increased use was being made of SBs, he noted that the roles these boards are required to play is related to the parent corporation's strategy in the host country.

Björkman (1994) presents the results of a survey on the use of SBs in French and Norwegian units owned by Swedish and French MNEs. Although for many MNEs the role of SBs was limited, in those firms that used their SBs actively, strategy and budget approval were considered as important roles. These findings contrast to those of earlier studies in which budget participation and strategy formulation were not functions performed by SBs (Kriger, 1988, 1991; Leksell and Lindgren, 1982).

Using Canadian data, Gillies and Dickinson (1999) conclude that despite the benefits "strong, relatively independent subsidiaries" can bring to MNEs, SBs are not playing an increasing role in the operations of MNEs. In fact, contrary to expectations, the authors (Gillies and Dickenson, 1999, p. 242) find that "the role of subsidiary boards is rapidly declining".

In a more recent study, Strikwerda (2003, p. 55) focused on the devolution of powers from parent corporate boards to SBs, concluding that while devolving powers may involve "angst and anxiety" for the parent corporation's board, they should encourage their SBs to act as independent corporations to meet the demands of changing markets and technologies, adjusting the SBs' decision-making powers as the business environment evolves.

Theory development

While models concerning the factors which shape differences in international governance practices, such as that proposed by Aguilera and Jackson (2003), provide a rich exploration of differences in governance practices of the main board for firms whose head office and major sources of capital are located in a specific country, these influences apply to a much lesser extent in determining wholly-owned SB structures.

Wholly-owned subsidiaries are often equity funded by the parent, which removes the impact of local equity capital markets in shaping subsidiary governance needs. Local debt funding may be used to meet some of the funding requirements of the MNS. However, such debt funding will be monitored through lending covenants and often parent company guarantees; consequently, having little or no impact on requirements for a SB.

As the scope of the paper is for MNS in countries in Anglo-American legal structures, the impact of labour in determining the SB requirements is unlikely to be a major factor (Aguilera and Jackson, 2003). Finally, many MNS have expatriate managers in senior management positions (e.g. Björkman, 1994; Kriger, 1988; Luo, 2005), which, while not completely removing the impact of management in shaping SB decisions, means that the factors which will shape the MNE board in its home country with respect to the influence of managerial factors on governance structures is likely to be less of an issue in determining SB requirements.

In extending the findings of the SB literature, we contend that previous writings have not explicitly attempted to link the conditions under which particular MNE strategies may be linked to different roles for SBs and consequently different board models for the MNS. To develop this contingency perspective we first briefly review a common model of MNE strategy which contrasts the key dimensions of the pressures for cost reduction and the pressures for local responsiveness required for the MNS's market. We then review the key governance roles that a SB may play. We use these role dimensions to propose four distinctive models for the use of a board in MNS governance. We then relate these models to the MNE strategies to propose that various MNE strategies favour different governance models. This discussion concludes with a series of research propositions based on the alignment of global strategy with governance models.

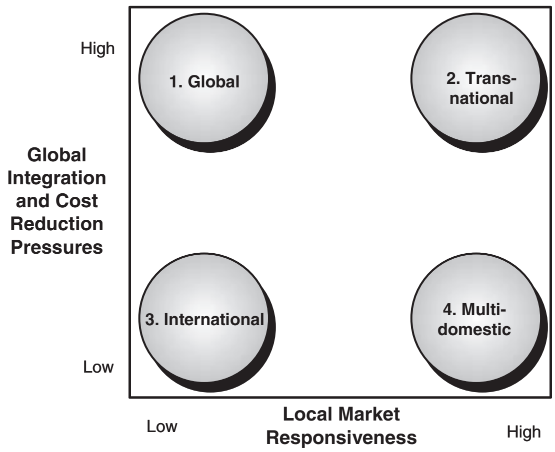
MNE strategies

As in the general strategy literature, there are numerous strategy models in international business (Hill, 2003). One model contrasts two major forces which any multinational must consider – the extent to which global strategy needs to drive for low costs and the requirement for products and services to be adapted for specific domestic market conditions. On the cost dimension, some industries globally need to drive for low global costs. For example, semiconductors are a global industry where cost drivers are all important and where significant economies of scale are available from production facilities geared to global markets. At the other end of the spectrum, building and construction industries are heavily reliant on local cost structures and there are no significant economies of scale in global operations.

A similar situation exists with respect to the need for product/service customisation to local market conditions. Again, the semiconductor industry requires no customisation for local market conditions and the same product can be sold in multiple markets, whereas building and construction is highly customised to meet local physical conditions, building regulations, and accepted construction practices.

Consequently, a popular model for considering global business strategy is to consider the alternatives which arise when considering cost reduction pressures on the one hand and the extent of local market responsiveness on the other hand. To simplify what are obviously a limitless number of options, commentators have categorised a parent corporation's strategy for competing in multiple-national markets into one of four generic strategies (Hill, 2003; Hill and Jones, 1998) (see Figure 1):

1. *Global strategy* – Corporations pursuing this strategy do not customise their products or marketing strategy for local markets. This strategy is used where there is pressure for global integration and cost reduction and the need for local responsiveness is limited. This strategy is often associated with industrial products.
2. *Transnational strategy* – This strategy is used where the pressures for cost reductions and local responsiveness are high. It has been argued that this is the new reality of many international markets (Bartlett and Ghoshal, 1992). These competing demands make this a difficult strategy to pursue. There is often a mixture of decentralised decision making at the subsidiary level and centralised decision making at the parent corporation level when following this strategy. Caterpillar, for example, has been



Source: Adapted from Hill and Jones (1998, p. 254).

Figure 1: Four basic strategies for entering and competing internationally

cited as pursuing a transnational strategy (Hill and Jones, 1998).

3. *International strategy* – Corporations using this strategy centralise their core competencies such as R&D and core marketing, but leave other decision making to subsidiary operations. The strategy involves establishing value creation activities in many of their international markets. This strategy is most successful where the pressure for local responsiveness is low, since corporations operating under this model incur high costs, as they tend to duplicate their manufacturing and related business functions
4. *Multidomestic strategy* – A multidomestic strategy sees the firm focus on local responsiveness, transferring skills and products to overseas markets. It is most successful when the pressure for cost reduction is low. As with an international strategy, there is often a duplication of manufacturing functions. A multidomestic strategy is often associated with substantial strategic decision making at the subsidiary level. This strategy can be observed among the large international construction firms.

The optimal strategy is based on a corporation assessing both the ability to integrate global operations and cost reduction pressures together with determining the need for responsiveness to distinct local market needs.

Governance roles

In the absence of any international system of corporate law, MNEs must operate within the legal boundaries of the countries in which their subsidiaries are located, regardless of their global business strategy. Under Anglo-American legal systems both private and public corporations are governed by a board of directors. It is therefore the board of directors of the MNS that will be most influenced by a parent corporation's control philosophy, since the parent board and management will decide the powers delegated to a SB.

The fundamental duties of a company director are established under law, for example, the *Companies Act 1985* in the United Kingdom and the *Corporations Act 2001* in Australia, and augmented with other statutory duties, such as health and safety regulations. Furthermore, common law (also called case law) uses court judgements to interpret statute law.

A director's major duties can be defined as: (i) a fiduciary duty to act in the corporation's best interests and to not benefit personally at the expense of the corporation and (ii) a duty of care and diligence to act with a reasonable level of dedication and expertise in the role.

To discharge these duties, a conventional board needs to undertake a number of governance roles, which can be gleaned from a number of prominent guidelines and recommendations on corporate governance. These include the *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX Corporate Governance Council, 2003) in Australia, *The Combined Code on Corporate Governance* (Financial Reporting Council, 2003) in the UK and the OECD's *Principles of Corporate Governance* (2004).

When considering the potential role of a board at the subsidiary level we suggest there are four main roles a SB board may potentially perform. These key governance functions can be summarised as follows:

1. *Strategic role*: For parent corporations, whether domestic, multi-country or fully global, it is generally accepted today that the board has a significant role to play in the formulation and adoption of a company's strategic direction. The question for MNEs is the extent to which a SB can add value to the strategic role at the MNS level.
2. *CEO role*: Again, it is now well accepted that for the parent board one of the major functions of the board is to appoint, review, remunerate, work through and replace (when necessary) the CEO. The board/CEO relationship is crucial to effective corporate governance because it is the link between the board's role in determining the organisation's strategic direction and management's role in achieving corporate objectives. The question for the MNE is whether head office or possibly regional management are best placed to perform this role with respect to the local subsidiary senior management or whether a local board can perform a meaningful role in this regard.
3. *Monitoring and control*: Monitoring corporate performance is an essential board function because it ensures that corporate decision making is consistent with the strategy of the organisation and with owners' expectations. With respect to the subsidiary, the question arises as to whether the monitor and control role is best performed by managers from a head or regional office or whether a functioning local board can add value in this respect.
4. *Access to resources*: Another way in which the board contributes to firm performance is by networking with its customers, suppliers and other stakeholders. All companies, whatever the size or nature of their business, need to attract outside resources to achieve organisational goals and net-

working is an important way of accessing those resources. Again, there is a continuum of potential needs for a subsidiary in this respect. This may range from minimal requirements for specific resources to be accessed at the local level, to situations where high-level access to government, customers, financiers or other key local providers of resources to the subsidiary are essential.

Finally, from a practical perspective, in considering governance roles at the subsidiary level, the MNE main board and management and any SB which exists and MNS management should be cognisant of the *OECD Guidelines for Multinational Enterprises* (2000). In particular, General Policy 6 of the guidelines maintains that MNEs should "Support and uphold good corporate governance principles and develop and apply good corporate governance practices" in the countries in which they operate.

Governance models

We now bring this literature on corporate governance and global business strategy together to suggest four possible models for SB governance. As is the case with global business strategies discussed earlier, these four models are for illustrative purposes, as there are an infinite number of variations available. The four governance frameworks we propose for subsidiary corporations are: (1) Direct Control, (2) Dual Reporting, (3) Advisory Board and (4) Local Board. As discussed below, each model has its advantages and disadvantages in the case of local subsidiaries.

Model 1 – Direct control

In Model 1, the subsidiary's corporate governance functions are undertaken solely by the parent corporation (Figure 2). The parent management structure governs the company. The subsidiary's legal board, comprised entirely of local managers, is a compliance board with no formal responsibilities outside those required under law (for example, conducting the annual general meeting and attesting to legal matters such as the annual corporate reporting to regulators). This model may also have matrix reporting of senior subsidiary line managers to equivalent line managers in the parent corporation. For example, the local HR manager may report to the local CEO and the parent HR manager.

Limited governance processes are required under this model. For example, board meetings are only held as required under law and are strictly formalities. The information flows are contingent upon the parent's requirements. The parent corporation will usually require extensive and regular financial reporting, and often seek to make or at least overview all major strategic decisions.

The major strengths of this model are that the parent corporation has direct control over the subsidiary. It will be able to attain global efficiencies through greater integration of operations and there will be clear reporting lines for the local CEO.

The major weaknesses are that the parent corporation may not adequately understand the local market when making key decisions, control of the subsidiary may be fragmented across multiple managers and, therefore, be less effective. Delays in decision making may also occur due to continually referring decisions to the parent's management.

Model 2 – Dual reporting

In Model 2 (Figure 3), the subsidiary's corporate governance is split between a local board and the parent corporation. As a result, the

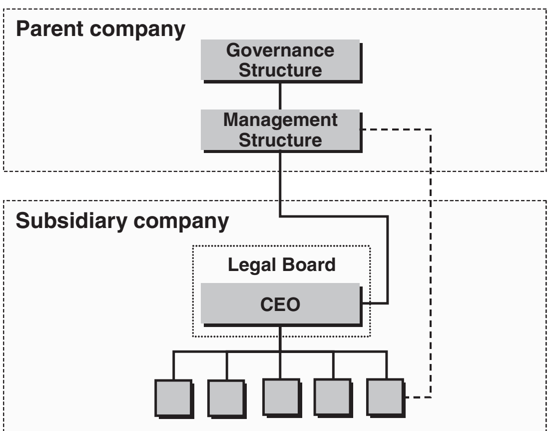


Figure 2: Model 1 – Direct control

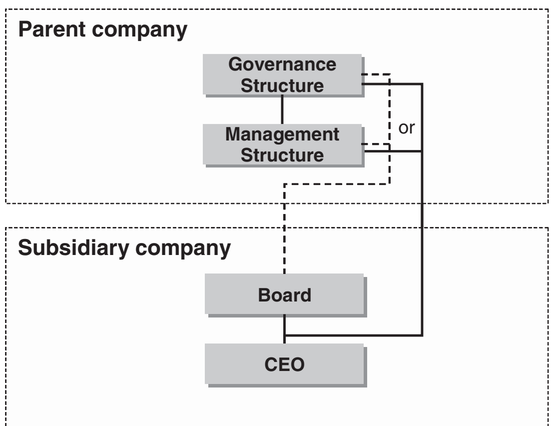


Figure 3: Model 2 – Dual reporting

subsidiary CEO has a dual reporting line to the local board and most often to the parent management structure. The local board also has a communication line to the parent governance or management structure.

The local board is legally constituted and directors have the resulting duties under the host country's legal system. The local board's roles are contingent upon the parent's requirements and delegations. It will typically play a stronger role in the governance roles that benefit from greater local knowledge and contacts. These roles include networking, stakeholder communication, compliance and policy making. It may also have a role in strategy and monitoring. Similarly, the parent's role in the subsidiary's governance depends on the roles it requires of the local board.

The strengths of this model are contingent on clear governance demarcation between the roles of the parent and the SB. They include: (1) improved understanding of the local market and networking ability compared to there being no local board; (2) creating management discipline by the SB CEO being compelled to regularly report to a board; and (3) the board being on the ground and able to provide advice and feedback directly to the CEO.

Among the major weaknesses of Model 2 are the potential for governance role duplication and inefficiency with management doing work twice or the parent and the SB performing overlapping roles. Further, the SB's role may be disempowered by the parent, which may also cause dissatisfaction amongst directors. There is also the possibility of uncertainty for the local CEO as to reporting lines; and the parent corporation managers and/or directors may become shadow directors of the subsidiary (and so have the same overall legal responsibilities as the SB directors).

Model 3 – Advisory board

A governance model sometimes observed is for the SB to create an advisory board. The advisory board contains local people who are not formally registered as directors, but who are given specific roles and responsibilities which mirror some of the roles of formal boards. Under Model 3 (Figure 4), the subsidiary's corporate governance role is undertaken solely by the parent corporation's management and is usually in compliance to local legal requirements as seen under Model 1. The subsidiary CEO reports to parent management. This results in the parent having direct control over the subsidiary's activities without the existence of an "active" SB. The advisory board has no decision-making power (unless specifically delegated by the parent corporation). The advisory board is allocated specific aspects of the four governance roles and it then counsels the CEO accordingly. These roles are usually those where greater local market knowledge or an on-the-ground presence is beneficial. As the advisory board only advises the CEO, the CEO is under no obligation to heed its advice. However, if the CEO consistently acts against the advice of the advisory board, then the board would be most likely restructured or abolished.

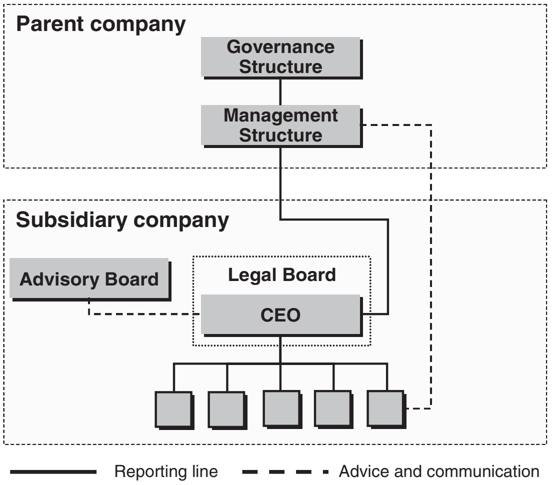


Figure 4: Model 3 – Advisory board

The major strengths of Model 3 are: the parent's capacity for direct control over the subsidiary; the subsidiary's ability to benefit from the advisory board's understanding of and contacts in the local market; the ability to nominate clear reporting lines for the local CEO; and advisory board directors are not subject to the duties of being a director and the associated risks, provided they do not act as "shadow" directors.

However, there are a number of weaknesses with Model 3. These are: that for a subsidiary with substantial local market responsiveness, the parent may not adequately understand the local market when making key decisions as time and distance may not allow more active involvement by overseas directors/managers in customer meetings, site visits, key corporate functions, etc., which are important to gain local knowledge; the potential for geographic isolation, time zone differences, cultural differences and local market conditions to inhibit appropriate monitoring and providing subsequent feedback to the subsidiary; the potential for decisions requiring resolution more promptly than the parent manager or advisory board meeting timings allow; and the additional cost of retaining and administering the advisory board in comparison to Model 1: Direct control.

Model 4 – Local board

Model 4 (Figure 5) sees the subsidiary's corporate governance undertaken entirely by a local board. This SB is legally constituted and directors have the resulting legal duties. The SB has full control of the subsidiary and performs all four board roles.

Under this model in its purest form, the parent corporation's role in subsidiary corporate governance is purely that of a shareholder. This shareholder role is undertaken by the parent governance structure or management structure. As the shareholder, the parent appoints the SB (consistent with its constitution) and may have some personnel on the SB. The SB then has full autonomy for governing the subsidiary's operations and is accountable for its performance and the subsidiary's performance to the shareholder. With regard to processes, the SB functions as a conventional board.

The local board is expected to assert strong control over subsidiary management; tight outcome (financial) control is used by the parent over the local board and management; and this model is often associated with corporations which have a multi-domestic strategy.

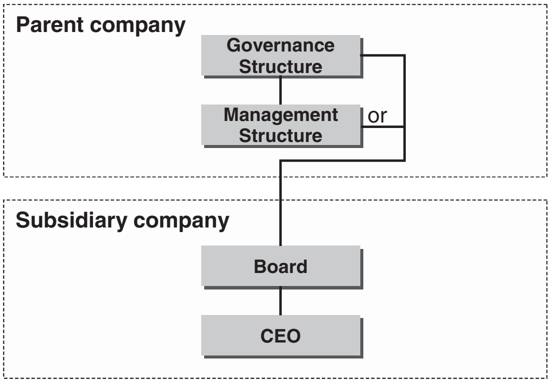


Figure 5: Model 4 – Local board

There are a number of major strengths associated with Model 4. These include the clarity in governance roles and that local decision makers have a strong understanding of the local environment. Minimum time and resource investment are required at the parent level when the subsidiary is performing strongly and the subsidiary has the ability to adapt to the local environment.

The major weaknesses of Model 4 are the difficulty in any overseas-based parent directors attending local board meetings; the parent corporation does not have direct control over the business; and the parent has little understanding of the local environment should it need to become involved in subsidiary decision making.

Propositions

Figure 6 shows how these four board models relate to the key board roles set out earlier. Each model is associated with a greater or lesser extent of delegation or expectation with each of the four key board roles. It is then possible to theorise that the different board models will perform more effectively depending upon the global strategy adopted by the MNE, which is depicted in Figure 7.

Dual Reporting (Model 2) boards are hypothesised to be better suited to international strategies, since head office still wishes to keep tight control over the MNS's activities, but at the same time a significant amount of assets may be located in the international market. The MNS will benefit by "on-the-ground"

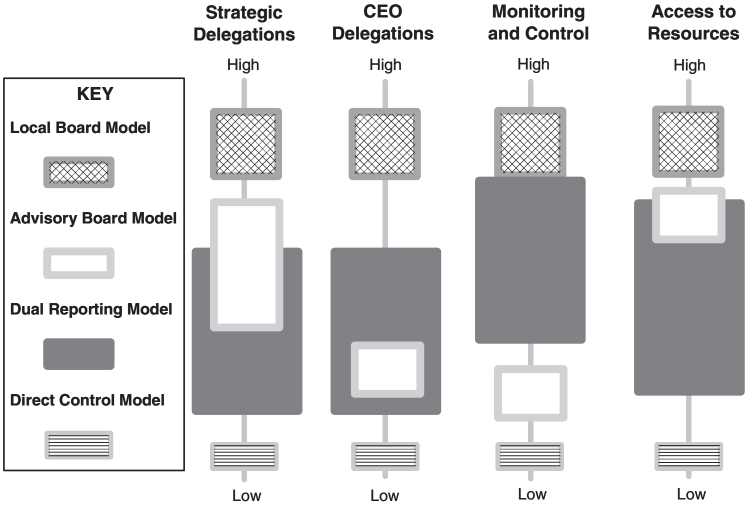


Figure 6: Board roles and board models

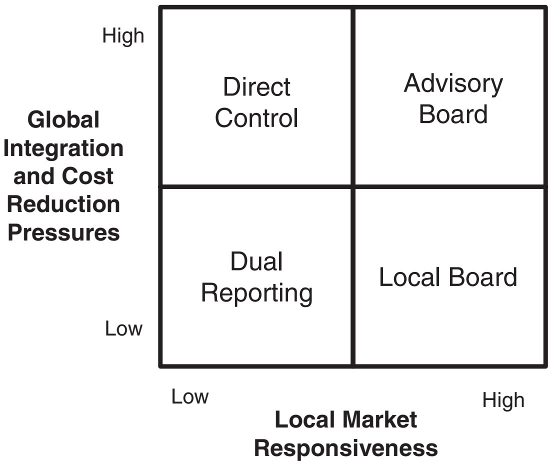


Figure 7: Board models and global strategies

directors tightly monitoring the use of these assets and also providing key links to local business communities and regulators.

Direct Control (Model 1) may be appropriate where there are few production facilities located in the domestic market and there is minimal local adaptation of product and services.

A Local Board (Model 4) may be the appropriate model where considerable local responsiveness is required and where significant local assets are located in the MNS's country. This governance structure allows for close monitoring of the use of these assets plus the local knowledge with respect to local market conditions, contacts to customers, regulators and other key interest groups.

Finally, an Advisory Board (Model 3) may be the appropriate model where a MNE is following a transnational strategy of pursuing both local market responsiveness and global integration. The advisory board can be tasked with those roles that require local contact and networks while not impeding decisions that are aimed at improving global cost reductions.

Related to these models we have developed a number of propositions. The first set of propositions couple international strategy with a SB governance model. Specifically:

Proposition 1: A Direct Control model is more likely to be associated with a global strategy.

Proposition 2: An Advisory Board model is more likely to be associated with a transnational strategy.

Proposition 3: A Dual Reporting model is more likely to be associated with an international strategy.

Proposition 4: A Local Board model is more likely to be associated with the multi-domestic strategy.

The second series of propositions relate the dimensions of international strategy to SB performance. Specifically:

Proposition 5: The Direct Control model coupled with a higher need for global integration and cost reductions, and a lower need for market responsiveness, will be associated with superior subsidiary performance.

Proposition 6: The Dual Reporting model coupled with a lower need for global integration and cost reductions, and lower need for market responsiveness, will be associated with superior subsidiary performance.

Proposition 7: The Advisory Board model coupled with a higher need for global integration and cost reductions, and higher need for market responsiveness, will be associated with superior subsidiary performance.

Proposition 8: The Local Board model coupled with a lower need for global integration and cost reductions, and a higher need for market responsiveness, will be associated with superior subsidiary performance.

Conclusion

This paper attempts to relate alternative governance models for MNSs with generic international business strategies. The paper makes a contribution by establishing a contingency theory concerning the governance control of MNSs. It also makes a contribution by identifying four fundamental models of governance available to MNEs and linking these back to the major roles which boards can play.

The paper has implications for MNEs in that it provides a framework to consider the use of contemporary corporate governance thinking to produce improved performance for international subsidiaries. We hope that the paper may engender debate in this area.

For researchers, the challenge is to test the model to determine whether the predictions contained in the eight propositions are found to hold in practice. One difficulty will be that previous research suggests that few MNEs have used governance models other than direct control. If this is the case, then deductive reasoning may require some MNEs to experiment with alternative governance models prior to large-scale empirical tests of the theory becoming a viable research strategy. It may be that case research, focusing on specific MNEs and their MNSs, may be a necessary first step in research.

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