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Management control systems for international operations

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During a sabbatical leave Dr. Woo visited fifteen large U.S. companies and their overseas units as well as ten European and Japanese companies in order to conduct an empirical study of management control systems for international operations. The Touche Ross International Executive Office aided Dr. Woo by supplying introductions to our overseas offices and to certain clients. His study is the result of his on-the-spot inquiry and interviews with key executives and managers and his analysis of the primary sources of materials provided.

I. Strategic Planning
Defining a Company's International Objectives and Organizational Structure

In this area, I found an encouraging trend in that an increasing number of the companies covered in this study have formalized, after carefully considering investment opportunities on a world-wide basis, a clearly defined and well integrated set of international objectives. Some companies have broad policies for the acquisition and use of the resources to attain these objectives. However, I found that almost an equal number of the companies visited have failed to systematically establish their objectives on a global basis, and still clinging to vague, fragmentary, isolated, and even outdated
ones. The latter condition has not provided, in my opinion, an adequate basis for setting up proper international organization and management control systems. This inadequacy is probably caused by the failure of top management to understand the importance of a formalized and well integrated set of global objectives.

Despite the increasing importance of their global business in recent years, a majority of the companies covered in this study have kept an international division which employs a separate corporate staff. In some companies, this division retains highly centralized authority; being independent of the domestic side, and reporting directly to the top management. In other cases it has lost its autonomous position and highly centralized authority. Its previous authority in broad policy matters has been taken over by a separate group in company headquarters charged with worldwide staff responsibility in planning and development. In either case, these companies have not developed a truly “multinational” organizational structure; that is, either a structure organized along multiple product lines headed by executives with worldwide product responsibilities, or a structure organized on a geographic basis and headed by executives with regional or country responsibilities.

A smaller number of the companies covered in this study have seen fit to replace the international division with several regional organizations which report directly to the top management. While affiliated companies in various countries are responsible for day-to-day operations, the regional organizations can coordinate and control more effectively and efficiently because their geographic proximity permits them to adjust to changing local conditions more rapidly.

Apparently no single form of international organization can meet the varying objectives and specific needs of all companies. It seems that large companies heavily involved in global business can best organize their international structure in one of the two basic forms. When a company’s product lines are quite different from one another, each requiring a highly distinctive process of research, development and production, and each of them has already reached an economy of scale on the global basis, it is desirable to structure the company’s international organization on product lines. Each product line executive at corporate headquarters is vested with worldwide authority and responsibility in his line of specialty. Common matters affecting various countries or regions are coordinated at the corporate or regional level (if regional organizations are established).

On the other hand, if a company’s products can be substantially combined on a country level, and if cross-fertilization of technology is not handicapped by geographic separation, it is logical to organize operating units on a country-to-country basis. The country units report directly to a top executive at the corporate headquarters or to a regional organization which, in turn, reports directly to the top management. Common matters affecting various products are coordinated at the corporate or regional level. In either case, there appears little or no need for retaining a separate international division at corporate headquarters. Any staff functions of planning and development at the corporate level can be performed by a single group having world-wide responsibilities.

II. Management Information Systems

There has been much discussion of integrated management information systems designed to serve all levels of management in different parts of the world. They would be built upon on-line worldwide communications networks with a series of computers at corporate headquarters and key spots around the world. One can point out many potential uses of such networks in engineering, production, marketing and financial areas. However, even for many giant-size companies, I have observed that fulfilling presently identified needs would not be justified by the extremely high costs of designing, installing and maintaining such systems. It appears, therefore, that the immediate issue in management information systems is not so much a real, current need for an advanced worldwide networks system as for the improvement of existing systems.

I have noted a general failure to substantially identify, under the constraints of a company’s objectives and organizational structure, the real needs of management, and to determine the relevancy and importance of information output. This results in a flood of paperwork containing irrelevant and useless data. Changes in key variables for the critical success factors of a company’s business, the most vital information needed by management, are often neither clearly identified nor singled out for management attention. Also, not enough efforts have been made to systematically collect, process, and
evaluate rapidly changing environmental forces in different countries of the world. For better utilization of human and economic resources, management information output must be selective—an important principle seemingly not followed by many of the companies I visited.

Another disturbing observation is that some management information systems appear far from coherent, consistent, or integrated, resulting in information output which is duplicate in coverage and even conflicting in content. It is conducive to different interpretations by different users, causing a breakdown of management communications.

III. Long-range Profit Planning and Capital Budgeting

A number of companies covered in this study have found it worthwhile to devote considerable effort to undertaking a formalized approach to long-range planning. Detailed procedures vary; but operating units in various countries normally submit, in accordance with corporate guidelines and instructions, their individual four- or five-year profit plans, which are then reviewed, coordinated and consolidated by the corporate office. The final plan for the entire company tends to be quite comprehensive, and the procedures for monitoring its progress are systematic and elaborate. Coordination is also effected between long-range plans and short-term budgets.

However, there seems to exist a common lack of competent economists, statisticians, and operation researchers in the corporate office who would be able to use advance knowledge and methods to explore and evaluate investment opportunities around the globe, and to forecast sales on a long-term basis. A few exceptions to this are noted. One company employs a group of experts of high caliber who attempt to quantify risk factors of long-term investments in some politically unstable and economically less developed countries. The task is extremely difficult since advanced methods have yet to be refined and established. Nevertheless, the efforts in finding a new path should pay ample dividends in the long run.

It is disappointing to find that a considerable number of managers still fail to recognize the time value of money and thus refuse to use the present-value method for evaluation of long-term capital expenditures. This theoretically superior method is rejected on the grounds that it is more difficult than the simple payback or traditional rate-of-return method, and that top management does not understand the use of a discount rate to compute the present value of future cash inflows. I believe that such persistent refusal is due either to lack of understanding of the supremacy of this method or to the erroneous impression that it entails complicated calculations.

Some companies use computers to facilitate screening, rationing and approving of capital projects. After they are put into operation, comparisons between actual results and projected figures of revenues and expenses are not made by computer print-outs. The process of follow-up has much value in checking the reliability of original estimates and thus correcting any shortcomings in projection techniques. When asked why such follow-up was not being made, one manager admitted that he could not give a satisfactory explanation.

IV. Short-term Profit Planning and Control Budgeting

Almost without exception all companies devote considerable time to setting up and enforcing an elaborate system of budgeting to plan and control short-term profits. The purpose is to maximize short-term profits—a target generally overemphasized, sometimes even at the expense of long-term objectives. U.S.-based companies, more so than their European- and Japanese-based counterparts, demand and scrutinize closely the results of operations month by month, and control major variances in actual results from budgeted targets.

Although line managers of operating units in various countries participate, to a greater or lesser degree, in the formulation of annual budgets, I cannot avoid the impression that many still view a budget as a negative device of restraint and pressure. Much has yet to be done to make budgets a truly motivating instrument. First of all, the budgeted goals, whether prescribed by corporate headquarters or initiated by operating units, must be reasonably attainable. Next, line managers on down to personnel at the operating level must have genuine participation in the preparation of budgets.
Budget modifications at the higher levels must be thoroughly discussed and agreed upon by all parties concerned. These requirements are particularly important in international areas where personnel of different cultural and social backgrounds generally have difficulty in understanding, without effective communications and actual participation in the budget process, the useful purpose of budgeting.

One company covered in this study employs a 100-point system as an incentive compensation plan for its international managers. Most of the 100 points are awarded on the basis of actual performance as compared with budgeted measurements of profits. Only a small percentage of the points are based on a subjective evaluation of personnel and general administration areas. The formulas for calculating the points are detailed in the incentive compensation plan which is circulated in advance to the managers being rated. This plan of monetary recognition for good performance, coupled with the budgets, has apparently worked well for this company as an effective means of motivation.

V. Profit Responsibility Centers: Measurement and Evaluation of Segment Performance

I was pleased to observe that the majority of the companies visited have established, within legal and other constraints, some form of profit responsibility centers around the world. To conform to the concept of responsibility accounting, the head of an international profit center must clearly be given commensurate authority and responsibility in planning, control and decision-making, and a great deal of flexibility in day-to-day operations. He must be motivated, while working under different cultural and other conditions, not only to maximize the best interests of his own center, but also to minimize, in a realistic sense, any conflict between the objectives of the center and those of the company as a whole. His performance must be measured and evaluated in terms of the items (such as revenues, expenses) over which he has substantial control.

Unfortunately, as far as can be detected, the reported profits of many responsibility centers in various countries are distorted, to varying degrees, by some allocated costs and transfer prices.

It is my opinion that corporate headquarters' and other indirectly associated costs should be treated as respective cost items which need not be allocated to international profit centers. If they must be allocated in accordance with the corporate policy, they should be shown on the income statement below the line as non-controllable items for which a profit-center manager is not responsible.

Transfer prices, to be equitable to both supplying and buying units, should be based upon market prices. If deviations from market prices are justified for tax, foreign exchange, or other reasons, market prices should still be used above the line on the income statement, with the differences shown below the line as non-controllable items. If market prices are not available, an alternative is for the profit centers to negotiate and agree upon acceptable prices.

International profit centers have responsibility for the satisfactory rate of return on their investments. This proves useful as an overall measurement as well as an indication of trends. For a more precise measurement of profitability, the concept of "residual income" can be used. Simply stated, this calls for a capital charge, usually based upon the cost of capital of the entire company, for the investment in an international profit center. The net income, after deduction of this capital charge, is treated as residual income and shown in appropriate monetary units. This method would avoid the possibility that a profit center might turn down an investment project yielding a smaller rate of return than its historical one, although still higher than the corporate overall rate of return. The capital charge is normally on par with or below the corporate rate of return.

A large Dutch-based multinational company employs replacement value of long-term assets and inventories for rate of return measurement. I was satisfied, after observing its actual methods and procedures, that the figures used for replacement value are generally reliable, although some minor trade-off of objectivity for relevance cannot be avoided. I concur with its management that this rate of return, based upon replacement value instead of historical costs during these more than two decades of continuous inflation, is a much more relevant and meaningful measurement. After talking to a number of managers in U.S.-based companies, I have concluded that their chances of using current or replacement value in computing rate of return are rather remote. The fact that current or replacement value is not acceptable for
external financial reporting in the U.S. strengthens the inertia of not innovating it for internal management use, despite the continuous necessity of estimating the current or replacement value of long-term assets and inventories for fire insurance purposes.

In conformity with the responsibility accounting concept discussed above, the income statement of an international profit center should be divided into two sections: the first section consisting of those revenues and expenses for which the manager has substantial control and, therefore, responsibility; the second section comprising those items for which he has no substantial control and, therefore, no responsibility. The latter items include allocated expenses from corporate headquarters and adjustments of transfer prices as mentioned earlier. If measurable profitability is used, and rightly so, as one major criterion for promotion bonus, and other incentives, it should be based upon the net income shown in the first section. The final income arrived at in the second section can be used to evaluate profitability of the unit, but not the performance of its manager.

When I discussed this new approach with some managers of international profit centers, the response was positive and enthusiastic. Currently, however, there are no signs that it will be accepted by corporate management. The net income being used today is generally the same for both the measurement of profitability of an international profit center and the evaluation of performance of its manager. This is detrimental to the motivation of international managers; it can even lead to incorrect managerial decisions.