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An Entrepreneurial Model of Corporate Governance:

Devolving Powers to Subsidiary Boards

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An Entrepreneurial Model of Corporate Governance:

Devolving Powers to Subsidiary Boards

As multinational corporations are sometimes built from a large number of separately incorporated firms, which may have a one or a two tier board, a practical question is "which powers should be devolved by the board of the parent company to the boards of the subsidiaries?". This question can be answered in a straightforward way by describing what parent companies do today and why. However, when the question is answered in the perspective of changing strategies, economies and technologies, a number of additional questions arise. "Should subsidiary boards have autonomous boards with independent, non-executive directors?" "Do traditional control techniques still work?" and "how can we delegate decision rights in a system of networked, mutual independent subsidiaries?"

Why should parent boards delegate entrepreneurial powers to subsidiary boards?

The need to delegate entrepreneurial powers, or more technically speaking, decision rights, to subsidiary boards is necessary for a variety of reasons. There are three reasons why parent boards should delegate decision rights to lower levels of the corporate organisation. The first is to enable the corporation to quickly anticipate or respond to local changes and opportunities in the market. If all decisions are taken by top management, this results in information overload at the top, and consequently delayed decisions and poor decisions due to lack of time. It takes too much time to communicate information up to the top and then all the way down to those who have to act upon this information. This is nothing new, we read in the Bible how the father-in-law of Moses advised Moses to delegate tasks and decisions to the rulers of thousands, the rulers of hundreds, and the rulers of ten (Dale, 1967: 10-11). Milgrom and Roberts, in answering the question "Does organisation matter?", describe how the once mighty, but hierarchical Hudson Bay Company (HBC) (chartered in 1670) lost their market the North West Company (NWC), which was organised as a partnership of traders. NWC was much more decentralised and, unlike HBC, they provided incentives for working in remote trading posts, which encouraged effort, imagination, flexibility and innovation, and motivated employees to grasp opportunities and to adapt to local situations. Only when the HBC mimicked the organisation of NWC were they able to regain their market share (Milgrom & Roberts, 1992: 7-9). Another often-quoted example is the case of General Motors compared with the Ford Motor Company. In General Motors Alfred P Sloan introduced the concept of the division, borrowed from Du Pont and explained specifically what decision rights would be delegated to the management of those divisions and which decision rights would be reserved for the centre. The market share which General Motors gained from Ford after the introduction of what Peter Drucker called *federal decentralization* is attributed to Sloan's decentralised organisation, but it should not be forgotten that Sloan did more: he also introduced the annual model up-date and innovations in the distribution of cars. Through Peter Drucker's *Concept of the Corporation* (Drucker, 1946), Sloan's approach became the model which showed management how to organise large complex firms through decentralisation. The success of General Motors legitimised the model and turned it into a norm.

A second reason for decentralising decision powers is based on ethics. It was for ethical reasons that Du Pont first introduced the business unit in 1918. The owners of Du

Pont, who came from France, took with them the ideals of the Enlightenment, i.e. the responsible individual whose word could be trusted (Dale, 1960). Drucker also refers to the ideal of the responsible individual, as reflected in the US constitution. Drucker quotes the management charter of General Electric's Lamps Division which paraphrases the US constitution by saying: 'All authority not expressly and in writing reserved to higher management is granted to lower management'. "This is the opposite of the old Prussian idea of a citizen's rights, i.e. 'Everything that is not expressly allowed is forbidden'" (Drucker, 1954: 141). A corporation being a part of society should reflect in its organisation, and its management style, the values of that society in terms ofaccordance with both a man's self-image, and in respect for the individual.

A third reason is that of developing managers. Individuals need opportunities and situations to develop into managers and into directors. They need the opportunity to experiment and to discover for themselves what works and what does not. They need to make errors and to feel the consequences of their mistakes. Little of what is needed to be a successful manager or director can be learned through books. As in any profession, management and directorship require a considerable amount of tacit knowledge. Management is not simply about producing products. It is a responsibility of managers also to develop their subordinates into managers in order to produce the next generation of managers and directors. The situations in which individuals can develop best are entrepreneurial positions in which they can develop and learn by applying their own judgement. For this they need to have discretionary powers granted to them.

The heritage of legal thinking

Before we go more into depth about which powers should be delegated to subsidiary boards the question needs to be asked whether they should be subsidiary boards at all. By law a corporation has a board, whether one shareholder or a parent company, holds its shares. Because the powers of boards are defined by law, the question whether there should be subsidiary boards and what their role should be is usually considered from a legal perspective. However, the literature on management and organisational behaviour usually deals with managers, and management teams, not directors on formal boards. Also, the management literature is concerned with task structures, business units etc., and not with legal entities. Task structures are logical grouping of resources, and business units for implementing strategies and performance control. These terms are concerned with economic, technological, market and strategic factors, not with law. The organisation structure which an MNC uses to conduct its business may be completely different from its legal organisation. As a general rule an MNC's business organisation is determined by its strategy, the markets in which it operates and the processes used for development, purchasing, manufacturing and knowledge exploitation which may have global, regional or national economies of scale.

The legal organisation of an MNC in general is defined by the system of jurisdiction in national sovereign states; taxation arrangements as laid down in national legislation and multilateral tax-agreements, and to some extent, the history of acquiring independent companies. As there is no international company law MNCs are forced to operate through national subsidiaries. The role of these national subsidiaries is to provide a local 'plug-and-play' environment for the global business units or divisions. Of course some link has to be arranged between the business organisation and the legal organisation, for which various instruments exist.

Management's lack of awareness of the difference between the legal organisation and the business organisation is a source of much misunderstanding, especially for growing firms. Also, because business units and divisions work through different legal organisations they often have "quasi-boards" which have no legal basis. It is questionable whether a management team of a business which is not incorporated can have a board, as a board, in many parts of Europe, is an autonomous body whose members are not employed by the firm. In general, managers of business units and divisions are salaried managers who are answerable to a superior. This quite different from the position of a member of a legal board.

Three schools of thought in Organisational Behaviour

The powers of subsidiary boards should not be considered just from a legal perspective. They also need to be viewed from other perspectives such as management, organisational behaviour, management accounting and control. In business organisation there are three main schools of thought. The first school of thinking is represented by the literature on management and organisational behaviour. This school is rich in models, based on practical experience, psychological and economic theories and various philosophical ideas on human relations. The second school comes from company law and practice. This school concentrates on ownership rights, executive powers, and control of subsidiaries from an ownership perspective. A third school on organisational thinking is contained in the literature on management accounting and control. The invention of the business unit in 1918 by Du Pont was an innovation both in organisational thinking and in management accounting. The company also developed the Return on Investment tree to control their business units and divisions (Jensen, 1998: 131). The emergence of vertically-integrated, multi-divisional companies at the beginning of the twentieth century was also closely connected to the introduction of new techniques for management accounting (Jensen, 1998: 132) (Meyer, Boli, and Thomas, 1994: 135).

Within the field of management accounting and management control, a separate school of organisation concepts has developed, defining the organisation in terms of profit centres, cost centres, etc. This has little connection with the organisation concepts used in organisational behaviour. However, management accounting and management control has to be linked with both the organisational structures developed following from business thinking and organisational behaviour on the one hand and the legal organisation on the other. The system of management control has to produce both the reports for management and the external reporting required by the various jurisdictions where the firm operates, for local (tax) authorities and often for local shareholders.

These three different schools developed and coexisted within the context and the institutions of the second industrial revolution (i.e. prior to the information revolution). But, fundamental changes are now occurring in the economy and so management theory and organisational behaviour, the legal concepts of the firm and our systems of management accounting and management control must be reviewed.

What powers are traditionally delegated?

What roles should corporate boards perform?

To answer the question "What powers should be delegated?" we need to understand the division of roles and tasks between the board of the parent company and the board or management team of a subsidiary.

Alfred Chandler explained the distinction between the two levels of management: "…[business] administration is an identifiable activity … it differs from the actual buying, selling, processing, or transporting of the goods, and … in the large industrial enterprise the concern of the executives is more with administration (co-ordinate, appraise and plan) than with the performance of functional work" (Chandler, 1962: 8-9). This distinction as described by Chandler is incomplete because it does not take into account the legal perspective, the accountability to shareholders, or the perspective of management control, in monitoring subsidiary boards. R I Tricker defined four governance processes and roles for the board: *Direction*, formulating the strategic direction for the future of the enterprise in the long term; *Executive Action*, involvement in crucial executive decisions; *Supervision*, monitoring and oversight of management performance; and *Accountability*, recognising the firm's responsibilities to those making legitimate demands for accountability (Tricker, 1984: 7). Tricker's model immediately raises the question: How is this direction, the strategy formulated by the board, to be implemented? Is it by setting objectives for subsidiaries or is more required? Clearly boards need to make an effort to drive the business forward and to achieve results. First, they need to define the mission of the company, what it stands for in society, its contribution and its values (including its risk profile). This is usually expressed in a Mission Statement but, more important, is the behaviour of the board by which the practical consequences of that mission statement will be carried through in all parts of the corporation. This is the *formative* role of the board (Bleicher, 1992: 69), (Theisen, 1991: 206).

A second role is the *performance* role, which is about developing strategies through which the mission will be accomplished (including the business scope, the resource scope), implementing the strategy by setting objectives, allocating resources, the design of the overall organisation (administrative, operational, legal, management processes), the acquisition and development of resources (human, financial, knowledge, technology etc.), and delegated and non-delegated decision rights. This role also includes the creation and maintenance and the "social capital" of the organisation of the corporation, i.e. its key relationships with customers, employees, suppliers, and the community. A third role is the *conformance* role. In this role the board performs its duties towards shareholders, publishing financial statements, and seeing to it that the integrity of the corporation is maintained, including the stewardship of its assets and maintaining the reputation of the corporation (Tricker, 1994). These three roles, the *formative* role*,* the *performance* role, and the *conformance* role, can be elaborated in a list of normative questions against which a board can audit itself or be audited to determine whether it does a good job or not. In discussing the relationship between the parent board and subsidiary boards of one of my clients, a CEO of an MNC, we defined three roles for the parent board, which have proved effective in the CEO's communication with his managers and which cover the three theoretical roles discussed above. The three practical roles of the parent which this CEO decided to communicate to his subsidiary boards were: the *ownership* role, the *entrepreneurial* role, and the *enabler* role. Ownership covers issues of accountability, reporting, maintaining integrity and stewardship. Entrepreneurship means setting direction, setting objectives, initiating new business and closing or divesting mature activities. Enabling means creating the right environment using resources, infrastructures, patterns of communication, exchange and sharing of knowledge, management development, etc., so that individual subsidiaries will perform better than if they were operating independently.

The three roles defined by this CEO sound quite logical but their value can only be understood in the perspective of the historical development. After the second world war, the divisional structure was developed by Alfred Sloan of General Motors, and it was copied by many other firms. So generations of managers became accustomed to working within the concept of semi-autonomous divisions. With the growth of these corporations more decisions were delegated to subsidiaries and divisions. As a result of this, entrepreneurship came to reside mainly in these subsidiaries or divisions. This development was reinforced by the "business portfolio" concept which was introduced by Igor Ansoff in 1965 (Ansoff, 1988). This concept encouraged the creation of highly-diversified firms with unrelated portfolios, and a further decentralisation of decision rights and entrepreneurial roles. Corporate boards became "portfolio investors" with just a shareholder role. Corporate boards became intermediaries between the capital investors and the subsidiaries and the corporate boards which formed unrelated portfolios of businesses often failed to create added value for the owners. This became clear when improved information systems enabled capital investors to judge for themselves the performance of the individual businesses within the company portfolios. Also, these corporate boards often failed to add value to their subsidiaries because either the board failed to understand the businesses of the subsidiaries, or the management of subsidiaries were capable to develop strategies and deliver an efficient performance which corporate boards could not improve. In a number of cases these "conglomerates" were broken up after their break-up value was more than their market value, or they were stripped down to their original core activities (Hoskisson & Hitt, 1994).

However, the concept of the quasi-autonomous division, business unit or subsidiary proved to be a successful model. Also, it answered the need of individuals and groups to create subcultures within large monolithic organisations. So, the concept of the quasi-autonomous, self-contained division with its entrepreneurial role and local autonomy became an accepted organisational structure for generations of managers (Prahalad & Bettis, 1996). As board members often have their first work experience in this type of organisation, the quasi-autonomous division has also become accepted in their thinking, and influences their thinking about what roles to assume. In a number of cases board members are reluctant to change the business scope of certain divisions or to change the resources they are allocated in order to exploit synergies. So corporate boards often do not perform any entrepreneurial role at all, and they do not create the right conditions for entrepreneurship in their subsidiaries. On the other hand, managers of subsidiaries and divisions in many cases are fiercely opposed to the corporate board extending their entrepreneurial role beyond the allocation of investment funds. Often they argue that when the corporate board assumes a truly entrepreneurial role this is a breach of confidence. To claim that the parent board has three roles - ownership, entrepreneurial and enabling - means overcoming three restrictive patterns in collective thinking and it is a sign of true leadership, placing the interest of the whole company above the maintenance of personal relationships.

It was Alfred Sloan, Chairman of General Motors, who for the first time made explicit what powers should be devolved to the managers of a division and which powers should be reserved to the centre:

1. Set the business scope of a division, e.g. for which price segment a division would develop, manufacture and market cars.
2. Set a strategic direction for the division and the objectives, financial and non-financial, which should be achieved.
3. Finance the division.

4. Select, appoint, assess, remunerate and dismiss the management of divisions.
5. Monitor the performance, including the efficiencies, of the division.
6. Create the conditions for the exchange of knowledge, experience standards etc., by establishing committees on various functional issues.

Apart from these tasks, all other decisions, on product development, production, the supply chain process, hiring of staff, etc., should be at the discretion of the management of the divisions (Sloan, 1986). Sloan strongly pursued decentralisation but, he ran into some contradictions which we also see happening in many firms today. In 1920 Sloan wrote in his "Organization Study" for General Motors:

> "1. The responsibility attached to the chief executive of each operation shall in no way be limited. Each such organization headed by its chief executive shall be complete in every necessary function and enable[d] to exercise its full initiative and logical development.
> 2. Certain central organization functions are absolutely essential to the logical development and proper control of the Corporation's activities (Sloan, 1986: 53)."

Sloan based his approach on the system which had been developed by Du Pont. "The highly rational managers at Du Pont continued to perfect these techniques [for administrative organisation], so that by 1910 that company was employing nearly all the basic methods that are currently used in managing big business" (Chandler, 1977: 417).

The basic system as formulated by Sloan is still the model for devolving powers to boards of subsidiaries, irrespective of their legal organisation. But this is not the full story. Legally, when a parent company delegates decision rights and resources, the delegation is normally restricted to the use of assets (*ius utendi*), the right is not delegated to the income from those assets (*ius fruendi*) nor the power to sell the assets (*ius abutendi*) (Furubotn & Richter, 2000: 77). In the United States corporations prefer to be incorporated in Delaware in one single entity. Business units or divisions are not incorporated, nor as in the UK, are they "nearly incorporated". In such situations the phrase 'devolving powers to subsidiaries' really applies. Many corporations have acquired their subsidiaries as part of a growth strategy or to gain access to specific markets. In Germany there are several kinds of corporations *(Konzern)* in which subsidiaries maintain their full legal status. There is even a specific type of *Konzern* in which a subsidiary can apply at court for an *Ausgleich* when the management feel they have been damaged financially by a decision of the *Konzernleitung* (Forum Europaeum Corporate Group Law, 2000). In many corporations the board of a corporation does not devolve powers to subsidiary boards. On the contrary, this main board must decide which powers to take *from* subsidiary boards in order to create a corporation with a clear centre for co-ordination and to exploit synergies between subsidiaries. In Europe a number of distributing organisations have developed through one firm starting businesses in a number of countries as importing wholesalers and selling to independent firms each managed by an entrepreneur. In the next phase the lead firm takes a minority share in the independent firms, leaving the original owner-manager as chief executive of the firm. Later the manufacturer (e.g. a Japanese multinational) buys all the shares of the importing wholesaler in the countries where it markets its goods. An example is Sony, which took over Brandsteder in the Netherlands in the early 1980s. In that company the original owners were kept in place for their entrepreneurship, and they were allowed to run their local businesses as they saw fit (Kashani, Kassarjian & Shaner, 1998).

When the European market started to integrate, distribution became more pan-European, and companies like Sony and Philips were forced to change from a system of national subsidiaries to form one integrated European operation (Kashani et al., 1998). This was a painful and slow process. Boards found it difficult to interfere with the autonomy of the national managers, although they were salaried managers and although the parent company owned 100% of the shares. Boards found it extremely difficult to see themselves as owners of these national subsidiaries and to run them as parts of one European business. This has slowed down the introduction of pan-European account management, warehousing, information systems and pricing policies. However, certainly in the case of one hundred percent shareholding, the capital markets expect boards to run corporations as one system, not as a portfolio of unrelated businesses. The reluctance of parent boards to take back powers from subsidiaries is a demonstration of the close personal and emotional relationships which exist between members of parent boards and directors of subsidiary boards.

In general, the following decisions are delegated to the boards of subsidiaries:-

- Product innovation and product policy
- Pricing and market positioning
- Sales, distribution and marketing
- Product development and process development
- Manufacturing and procurement
- Hiring staff (remuneration which depends on local system of industrial relations) but not first level management of the subsidiary
- Investments in equipment and some other assets (but not real estate).

And the following powers are usually reserved for the board of the parent company:

- Setting the business scope of subsidiaries, product divisions, etc.
- Accounting standards, rules for consolidation
- Financing operations, changes in share capital and international cash management
- Corporate resources: patents and trademarks
- Ownership of real estate
- Official reporting, annual reports, fiscal reports, government relations, relations with shareholders and capital markets
- Changes in the legal system
- Guarantees to third parties, pledges on assets
- Cash management
- Acquisitions and divestments, mergers and alliances
- Management development policies
- Appointing the top management of subsidiaries
- Major restructuring and large volume lay-offs.

These lists are based on observations of the author in his work as management consultant, and on systematic research conducted for clients.

Specific arrangements differ from company to company, depending on a variety of parameters: the size of the company, the nature of the business, the local legal system, the history of the corporation, the risk profile and the experience and the personality of the directors. In large and older multinationals the system of "internal governance" in most cases is well established. It is in smaller firms, which grow from a small business to being the parent of a number of operating companies, and which grow from doing international business to becoming a multinational, that directors and managers have difficulty in finding their way. Directors find it particularly difficult to develop a balanced system of delegated and non-delegated powers. In 1987 we conducted a survey in the Netherlands on this issue. We found that for a majority of corporations, boards are inconsistent in balancing delegated and reserved powers (see Figure 1).

STRATEGIC PLANNING & CONTROL IN DUTCH CORPORATIONS

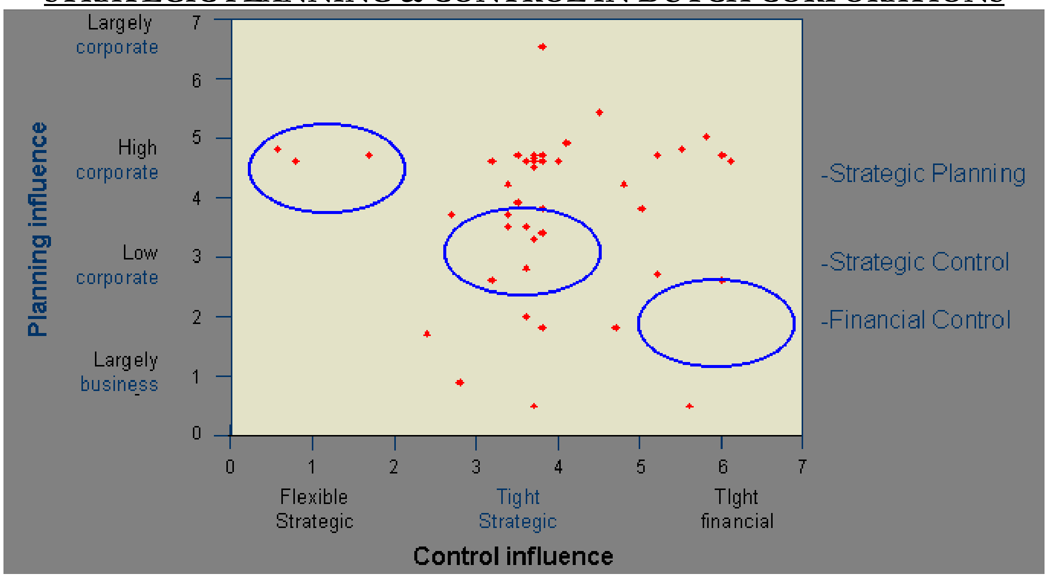

Figure 1. How in a number of boards in the Netherlands there is inconsistency between the type of control and type of influence. (Each dot represents a response of a corporation) (Strikwerda & Hest, 1998).

Linkages between Boards

The lack of clarity with which decision rights are delegated may also be related to whether a board is free-standing or there are linkages between the parent board and the boards of the subsidiaries. In some companies a member of the parent board also serves as a director on the executive board of a subsidiary, or the CEO and Chairman of a subsidiary is also a member of the parent board. The staff of the subsidiary believe they are "represented" by their manager on the board of the parent company and he looks after their interests. Working as a member of a free-standing parent board or having linkages between the parent board and the subsidiary board can have advantages and disadvantages. For a free-standing parent board the advantages are that monitoring and execution are separated, and strategic thinking and operational management are separated. The disadvantages are that there is "information asymmetry" between the parent board and subsidiary board and the company pays extra costs for recruiting additional directors. One advantage of having linkages is that there is more equal information between the parent board and the subsidiary. The disadvantages are that strategy and execution becomes mixed and execution drives out strategy. A second disadvantage is that the subsidiary management "marks its own examination papers". Also, depending on the chairman, a culture may develop in which board members refrain from asking critical questions to colleagues in the expectation that their colleagues will refrain from asking difficult questions of them. Connected with this a conflict of loyalties. A director who is a "linch pin" between a subsidiary and the parent board is torn between being loyal to the people in his subsidiary and his accountability for the parent corporation. This conflict may result in a "*governance overhang*".

Whenever the parent board considers starting up a new business in addition to the existing subsidiaries, the members of the board will tend to judge that proposal from the point of view of their subsidiary, not from the perspective of the company as a whole. There are many companies where this has stifled innovation and new ventures (Zingales, 2000).

Problems with Delegation

So what goes wrong when powers are delegated from parent boards to subsidiary boards? Below is a list of issues frequently encountered by management consultants:

- Central staff departments retained functional authority and this tended to erode the entrepreneurial spirit in subsidiary boards.
- Co-ordinating committees at headquarters became decision-making bodies. This inhibited decision making at the divisional level. In a number of cases headquarters staff were too much involved in the details of planning. This put more emphasis on control than on entrepreneurship.
- In a number of cases in Europe the executive board did not provide clear direction. This enabled divisions to compete with each other.
- In a number of cases the logic of the divisions was ill-defined in terms of business scope and resource scope. This led to overlaps and territorial disputes.
- Divisions (OpCo's) became sacrosanct over time. As a result the executive board did not have the guts to restructure the corporation.

In addition to looking at the details, the practice of internal governance should be judged from the perspective of the economy. The decentralisation which has been achieved through applying the "M-form" structure devised by Alfred Sloan has contributed significantly to the economic growth after the Second World War (OECD, 1987). Sloan's major achievement is that his model has created opportunities for many executives to act entrepreneurially, especially those who do not have the background and personality to be independent entrepreneurs, but flourish in a situation that is half-way between a market and a bureaucracy.

The danger of thinking in normative terms, about which decision rights to devolve to subsidiaries, is that development and innovation may be blocked. As we will see in the next section, Sloan's model and the variations developed in Europe were conceived and worked well under specific economic circumstances. The decisions about what powers to devolve now have to be viewed in a perspective of changed developments in markets, technologies and changes in society.

What are the challenges to the existing system of governance within the firm?

The system of internal governance used to control the multi-divisional organisation, or a parent company with wholly-owned subsidiary boards as they have been deployed for over seventy years, cannot be expected to last for ever, or to be applicable in all situations. Three new developments have occurred that challenge the Sloan model for internal governance: the increased efficiency of the market, the changing nature of the firm, and the changing nature of the knowledge used in the firm.

The increased efficiency of the market

Authors like Chandler have explained why the large vertically integrated, multi-unit business enterprise came into being after 1840 (Chandler, 1977). In a number of industries, (e.g. metal-working) factories produced a faster flow of goods than the market could deal with. This faster and more precise co-ordination of production was accomplished by a new professional in the economy - the manager. Also deficiencies in the markets for capital and qualified labour forced entrepreneurs to form vertically-integrated organisations.

The availability of capital differed from country to country and this, combined with the changing roles of banking institutions, and the anti-trust laws in the US, led to the construction of vertically-integrated corporations in the US, Germany, France, Belgium and the United Kingdom (Scott, 1987) (Blumberg, 1993). The nature of these corporations varied. Some were organised in one company; others were holding companies with a number of related or unrelated firms (Scott, 1987: 222). Reflecting on the development of large corporate groups, the economist Ronald H Coase asked the question "Why was there such a growth of large firms where the supply and demand of resources were not settled through a market but decided in a managerial hierarchy?" (Coase, 1991). He concluded that large firms come into existence and will remain when the co-ordination of economic activities through managerial hierarchies is more efficient than co-ordination through the market with its arms-length contracts. To be sure, other motives do play a role in creating large integrated firms and/or holdings companies with a variety of businesses: creating spheres of influence to protect a core business (D'Aveni, 2001), creating cash flows from unrelated businesses in order to be less dependent on the capital market, or simply to build an empire to boost the personal ego of the entrepreneur and to satisfy his hunger for power.

Since the Second World War the market mechanism has become much more efficient because of the development of improved and cheaper communications and the introduction of information technology, deregulation, public standards (e.g. DIN) and better education and training. As a result, transaction costs were reduced, the enforcement of international contracts became simpler, and the number and quality of suppliers increased, so that integrated firms no longer needed to operate certain activities themselves to ensure a secure supply chain. With the improvement in the efficiency of the market mechanism, the degree of vertical integration in large firms was reduced partly through divestments and partly through outsourcing. In other cases holding companies, like Hanson Trust, were broken up into independent firms because these financial holding companies were unable to produce added value in relation to the capital market and from the point of view of the subsidiary companies. The increased efficiency of the market mechanism also placed higher requirements on the boards of parent companies to add value, through the process of resource allocation and by creating an internal company environment which would enable their subsidiaries to compete successfully with independent firms. To achieve this, the role of the parent board has to move beyond ownership, co-ordination and control as defined by Sloan, to include entrepreneurship.

The Changing Nature of the Firm

The reference model for the relationships and division of roles between the parent board and the subsidiaries is based not only on the concept of the integrated firm, but also on the concept of the legal enterprise. "That is that each corporation is a separate juridical person, even when owned and controlled by another corporation with which it conducts a common business enterprise" … "However, in an era of multinational corporations, where … major economic activity is overwhelmingly conducted by centrally-controlled corporate groups consisting of scores or even hundreds of affiliated corporations … entity law has become hopelessly anachronistic. The entity law concept of the corporate juridical personality no longer matches the economic reality" (Blumberg, 1993: 100). In different jurisdictions, legislators try to transcend the concept of entity law in order to treat a corporate group of legally separate firms as one economic and juridical entity. Under this interpretation the subsidiaries legally are independent firms and the formal relationship between the parent board and the subsidiary is that of shareholder. This statutory approach enables parent boards to co-ordinate the activities of subsidiary firms as if the parent is the direct owner of the assets contained in the subsidiaries.

Networked Firms

However, with the reduction of vertical integration in large firms, through outsourcing or simply divesting parts of the value chain, complexes of "networked firms" have emerged (Gomes-Casseres, 1996: 34-35). Each of these firms is independent in a legal sense. However the firms are dependent on each other and they take on different specialised functions so, from an economic viewpoint, they operate as one business. Usually one of the firms plays a leading role, both as an entrepreneur and in terms of power; this is known as the nodal firm or network manager (Doz & Hamel, 1998). This is not to say that all large firms will change into networks. Working within a network means working together in a different pattern of power relations and vulnerabilities. Each large firm has to find for itself the appropriate balance between being vertically integrated or being an orchestrator of a network of other firms. In a network the legal nature of the firm changes from being based on company law to being a network of legal contracts between various parties. This was how the European firm developed in the medieval economy from an association of individual entrepreneurs which later formed a partnership in order to finance international trade. A multinational like the Dutch-Anglo oil Company, Shell, is involved in about three thousand joint ventures. Such a group of firms requires a different set of administrative arrangements than those defined by Sloan for a company with many subsidiaries or divisions. We have seen a shift from control to accountability through hierarchy, to control and accountability through contracts.

The Changing Nature of Knowledge and its Implications for Devolving Powers

Another set of assumptions underlying Sloan's model for devolving powers to subsidiaries is about the nature of knowledge as a production factor in the firm. In recent times much has been written about "Knowledge Management". Knowledge Management itself is a minor issue compared to the changes in the nature of knowledge itself as it is exploited by modern companies. The first change is that the knowledge which is exploited by firms today has changed from "abstract, codified knowledge" (e.g. electricity theory and mechanics) to "concrete uncodified knowledge" (e.g. entertainment and news). Abstract, codified knowledge had to be embodied in products in order to be exploited.

However, with the introduction of digital technology and the Internet, concrete uncodified knowledge can now be exploited without being embodied in physical products (see Strikwerda, "*What's New About the New Economy, and What Isn't?"*, 2001). This change had led to a change in business models and a change in the organisation of companies. Walt Disney is a case in point. Its jewels, the movies, are held centrally, in terms of ownership and maintenance, but they are exploited through multiple "platforms", movies, books, theme parks etc. (Slywotzky & Morrison, 1996: 60). Unlike the Sloan model the resources are made available to the operating units, in terms of licences, but <u>not</u> in terms of ownership or operations. This organisation structure requires much more co-ordination between the operating units in order to avoid conflicts (Collis & Montgomery, 1997: 222, 242), than does Sloan's divisional organisation. As a consequence, the pattern of devolving powers to decentralised units in Walt Disney is different from the pattern in the traditional holding companies or the multi-division firm.

Who Owns the Knowledge?

A second change in the nature of knowledge as a company resource is the change from "generic knowledge" to "specific knowledge" (Jensen, 1998: 103). The knowledge used for execution, co-ordination, and control in the firms of the second industrial revolution was *generic* in nature. It was easy to transfer from person to person and this transfer was not unduly expensive. But now, with the increase in the number of professionals involved in business, and the shift from manufacturing mass-produced goods to differentiated, customised goods, and the shift from manufacturing into services, the nature of knowledge is changing from dominantly generic to specific. So it is not easy to transfer this knowledge between persons or groups. The consequences of this are two-fold. First, the costs within the organisation increase as the boss has less and less understanding of how his people achieve their results, and to produce efficiently the professionals need a proper environment - not instructions. Second, as knowledge becomes more and more bound to the individual who works with it, the knowledge that the individual takes with him or her from training outside the company he works for raises questions about "who owns the knowledge?".

Zingales (2000) argues that in the case of professional workers who are to a material extent owners of the knowledge they work with, they are also entitled to claim that they are part owners of the knowledge. Compare this with the assumption underlying management control in the traditional organisation, in which the *ius fruendis* (the right to the income from the knowledge assets) and the *ius abutendis* (the right to sell or licence the knowledge assets) are owned by the company alone. We can now understand that in the modern firm which is based on exploiting specific, professional knowledge, the traditional management control systems and the traditional patterns of devolving powers to subsidiary boards may no longer be appropriate nor effective. Some companies have tried to respond to this development by using performance-based pay. But this is a marginal solution. In essence, the central problem of control in the modern firm is the issue of ownership. To solve this problem, Jensen suggests we should change the employment contract between the firm and its professional employees, and offer them a contract as a supplier of information assets. This is a second mechanism through which the firm as a legal entity may be changed into a nexus of contracts. This situation, where knowledge is owned by individuals, can also be applied to subsidiary firms, especially those which are developing products and services in collaboration with their customers in order to supply differentiated, customised goods and services. In these situations the classical parameters for control fall short, and in a number of cases, due to this mechanism, the members of parent boards are heavily dependent on the goodwill of their subsidiaries or divisions.

These three developments, the increased efficiency of the supply market, the shift from the integrated corporation to the firm as a network of contracts, and the changing nature of knowledge exploited and used for control, have changed fundamentally the nature of the traditional firm. So management must be careful in using the Sloan model of the divisionalised firm.

How to delegate powers to subsidiary boards in a system of networked, mutually-dependent subsidiaries?

The traditional model for devolving powers to subsidiary boards is based on the idea that the divisions are self-contained, i.e. there is no supply of materials or consumption of goods and services between the divisions or operating companies. The reality is more complex.

For example, in the construction industry, operating companies are often functionally-based in purchasing, specialised works, supplying to divisions building homes and offices. In the electronics industry, a number of companies have their own components and/or chip factories which supply both to customers within their group and to customers outside the group. Parent boards have to set a policy on whether the settling of quantities and prices should be left to a negotiating process between the operating companies or whether the parent board should be the final arbiter between them. Practices differ strongly between firms, dependent on the nature of the business, size, ownership and other variables. A common-sense solution can be found at Walt Disney: "While Eisner and Wells encouraged division executives to resolve conflicts among themselves, they made it clear that they were available to arbitrate difficult issues. Senior management's position was that disputes should be settled quickly and decisively, so that business unit management could get on with their jobs" (Collis et al., 1997: 222).

Social Capital

The development sketched in the previous section seems to suggest a fragmentation of the economic process. In certain markets, the market efficiencies are high, and transaction costs are low, so the economic process has little friction, therefore the economies of scale are low and so the optimum unit of production is the individual. However, there are two forces opposing an atomisation of the economic process and therefore large complex organisations are likely to remain. The first force is that large complex organisations in our society represent a substantial part of the "social capital".. "Social capital means the stock of active connections among people: the trust, mutual understanding, shared values and behaviours that bind the members of human networks and communities and make co-operative action possible" (Cohen & Prusak, 2001: 4). The fragmentation of the economy would put at risk the social capital and, with that, the stability of our societies. In its turn, this could undermine the economic process and the welfare of our societies. In society there is a constant struggle to absorb the innovation we need while still maintaining the existing social capital (Strikwerda & Brouwer, 2001).

New Business Models

The concern for social capital coincides with a change in the nature of the economy and in the business models which companies are using. We are seeing a growth in generic technologies, especially digital technology which is applied to a large variety of products and capital goods. Resources like digital technology can be applied to a large variety of goods and this means that a broad range of products now have common resources. We are also seeing a change in distribution structures and a blurring of traditional segments. The personal computer is both a professional product and a consumer product. In the Netherlands insurance and banking firms have merged, to have a better financing of their operations and to reduce marketing and distributions costs through cross-selling. Technology firms, e.g. in automobiles, now supply integrated and customised sub-systems to their customers instead of separate components. *This requires key-account management and co-design teams organised across traditional quasi-autonomous business units. Such a strategy may change the role and status of traditional business units from being profit centres to resource departments, while the customer account is the primary business unit for control in the corporation.* This change is logical from an economic viewpoint, differentiated goods are created by combining specific knowledge from the customers with proprietary knowledge about the technology and the production processes but in the traditional divisional organisation this change is often incomprehensible to business unit managers and members of parent boards.
In our research we found that management in a number of firms feel the pressure to change their operating models (Figure 2), but they find it difficult to design new operating models which will work. Also, they cannot find an alternative structure to the traditional divisionalised organisation.

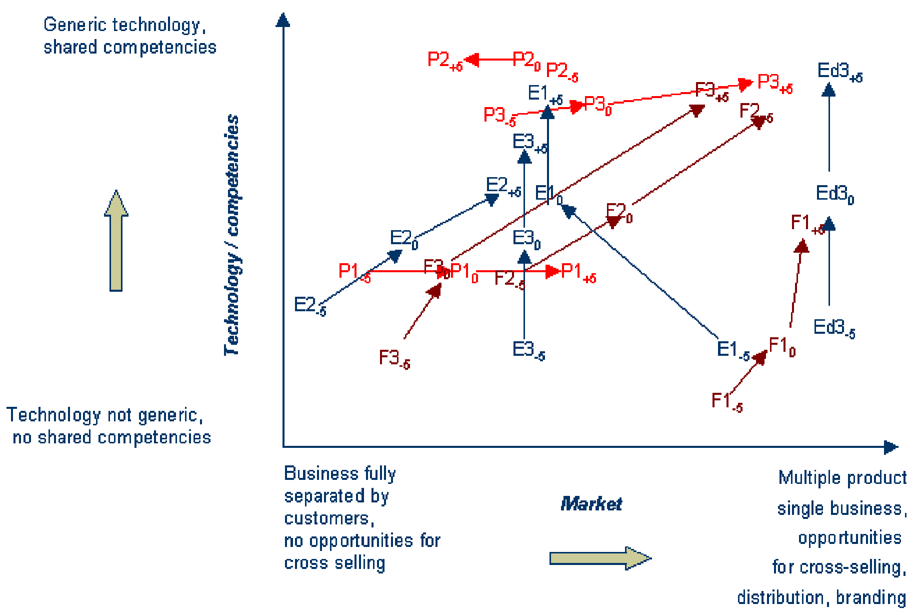

Figure 2. How Nine European Firms are Adapting to Cross-Divisional Linkages in Technologies and Distribution. *Development over time: 5 years ago, present (1999/2000), and in 5 years (expected); E = electronic firms, F = Financial firms, P = process firms, d = division. (Amerongen & Wijck, 2000)*
Note: The Technological changes are very different in the three types of industry - Process, Electronics, and Finance

Unbundling

A third change in the economy is what Hagel and Singer have called "the unbundling of the corporation" into firms that specialise in customer relationship management, in product innovation and commercialisation, and in infrastructure management (Hagel & Singer, 199: 213). However, due to the role of social capital mentioned earlier, this differentiation in functions is as yet only partially developed in the market economy. A number of firms, e.g. high-tech firms with capital-intensive manufacturing bases, and in the financial services, have adopted this differentiation of functions as an operating model for the organisation of their corporate groups (Strikwerda, 2000). As a result of technological change and shifting scarcities in the economy (for many industries the customer presently in the scarce factor in the value creation process) operating models are changing from the traditional divisionalised or holding company structures to more complex models (Figure 3).

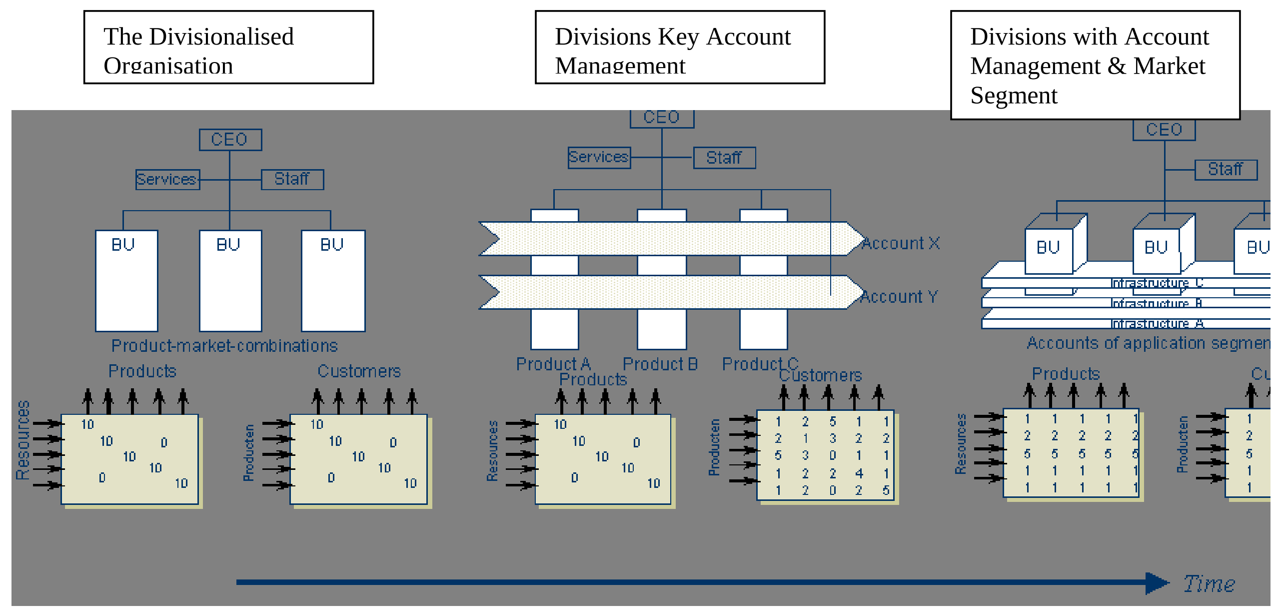

Figure 3. How the changing balance between resources and products and between products and customers is forcing corporations to adopt new, and more complex structures (Strikwerda, Nieuwe-werkende-organisatievormen, 2001)

These new structures are perfect for exploiting synergies, new customer relationships and new technologies. However, they are more complex to govern, because the operating units are no longer autonomous subsidiaries that can be controlled financially according to the Sloan model. The subsidiaries in the new organisations have inter-relationships and inter-dependencies. Therefore the planning and control of the corporation cannot be conducted in a number of parallel processes between the parent board and the boards of the subsidiaries. *Much planning has to be done between the subsidiaries* and this forces the parent board to adopt a different role. From a survey conducted in 1999 and 2000 with large and medium sized European firms, it was found that some of the firms needed to re-organise their businesses, but their managers could not define what form their new structure should take. (Amerongen et al., 2000) (Figure 4).

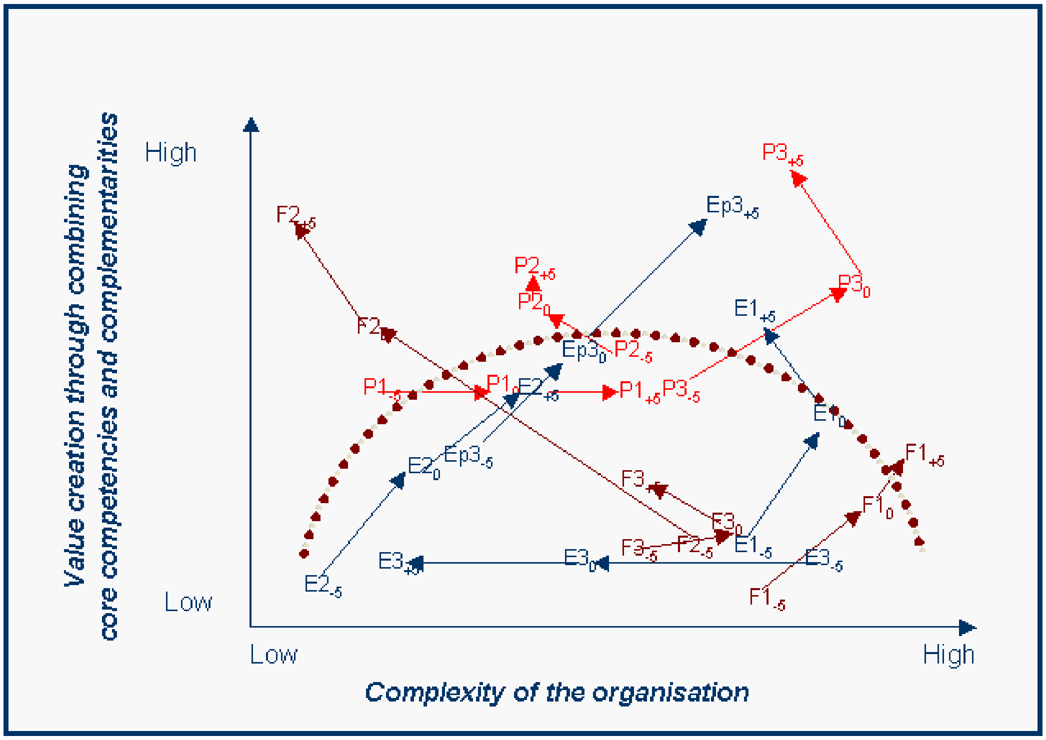

Figure 4. How a number of European firms are attempting to deal with changing markets & technologies (Amerongen et al., 2000)

New Organisation Structures

Some firms are taking the lead in developing new organisation structures. One high-tech global business redefined its organisation as a number of "virtual" business units, together with an infrastructure for development, manufacturing, logistics and sales. Each unit in this model has an entrepreneurial role complementary to the others. None of them is self-contained and they all depend closely on each other to accomplish their own tasks and the overall task of the company (Figure 5).

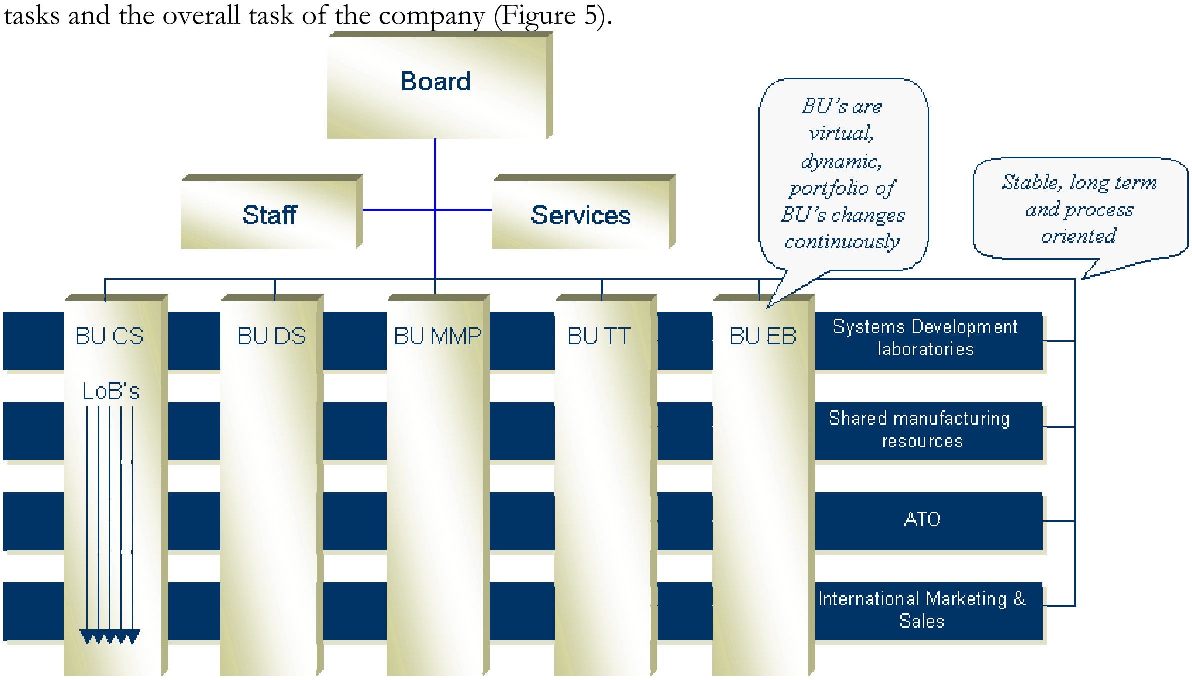

Figure 5. The Overlay Organisation of a high-tech firm. The company changed from being organized in self-contained business units, to a combination of permanent infrastructure and dynamic, "virtually" organized business units, providing its management with improved transparency and more strategic flexibility.
Note: ATO is an operation for testing and packaging.

In the model shown in Figure 5 the management process for planning and control is different from the traditional planning and control process in the divisionalized or holding company. The strategic planning and budgeting process is shown in Figure 6. The role of the parent board is not so much to agree targets for each of the units. The managers of the Business Units then prepare Service Level Agreements with the managers of the resource units, who propose to the board the Budgets, Operational Targets and Investments required. The board then has the task of setting priorities consistent with the overall strategy and, most important, the board has to approve the Service Level Agreements. It should never be left to salaried managers because they are likely to "play it safe", they will develop risk-avoiding behaviour and may lose market share.

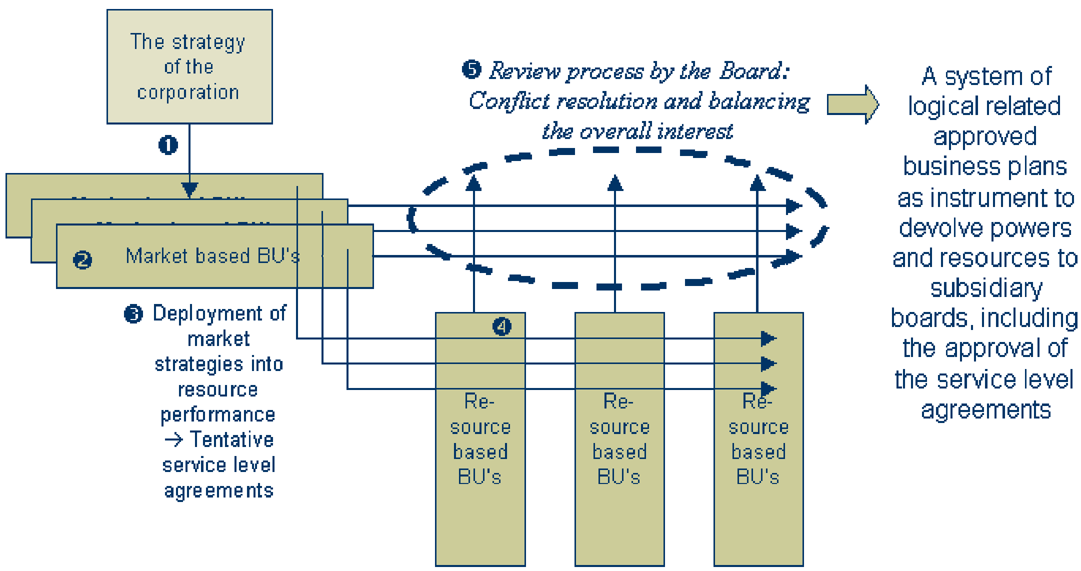

Figure 6. Strategy and Planning in a Modern Complex Corporation

In the concluding section we ask "What are the implications of these developments for devolving powers to subsidiary boards?".

Preliminary Conclusions: Devolving Powers to Subsidiary Boards in the New Economy.

Devolving powers to others whilst remaining fully accountable to the shareholders always involves an element of angst and anxiety. In the daily life of business many boards approach the issue of devolving powers, not in order to develop the business and to develop people, but rather from a perspective of how to remain in control.

For corporations operating in the economy of the 1970s and 1980s it was well known, which powers to delegate and how to remain in control.

The issue today is: how to devolve powers to subsidiaries with the new business structures as they develop in response to new technologies and changing markets. The risk is that directors will try to meet these new challenges with out-of-date concepts. They must wage a war on two fronts: they have to meet the needs of the new economy and they have to deal with the expectations of the new labour force of professionals who want to operate as independently as possible.

Parent board directors must realise that to exploit the new opportunities, new types of organisation structures have to be designed, before they devolve powers to subsidiaries. Boards can no longer be just substitute shareholders. More than ever before the role of parent boards is to be entrepreneurs and to create proper conditions for their subsidiaries to expand and grow. They must encourage subsidiaries to co-operate and to compete as if they were independent firms. Also, the decision-making powers of subsidiaries need to be adjusted periodically in response to changing business requirements.

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