UNIVERSITY OF TURKU
Turku School of Economics

SUCCESSFUL MANAGEMENT OF A FOREIGN SUBSIDIARY

Bachelor’s thesis
In International Business

Author:
Kai Routila

Supervisor:
D.Sc. Johanna Raitis

24.4.2024
Turku

Bachelor's thesis

Subject: International Business
Author: Kai Routila
Title: Successful management of a foreign subsidiary
Supervisor: D.Sc. Johanna Raitis
Number of pages: 28 pages
Date: 24.4.2024

Abstract

The purpose of this thesis is to examine how to successfully manage a foreign subsidiary. Many of the multinational enterprises consist of smaller companies, subsidiaries. Some of the biggest multinational enterprises have even over a thousand subsidiaries. Subsidiaries are extremely valuable to the multinational enterprises but in order to achieve the maximum value, they need to be managed correctly.

This thesis will first examine the establishment of a foreign subsidiary and find answers to why a firm would want to establish a foreign subsidiary, the choosing of the location and the different possible entry modes. The second part of the thesis will focus on aligning the goals and motives of the parent company and the subsidiary using agency theory. The third part will study the different roles subsidiaries should be assigned to and how the subsidiaries can benefit the whole multinational enterprise, especially because multinational enterprises have shifted from a decentralized structure to a network-based structure.

A multinational enterprise must have firm specific advantages that it can transfer to a location that provides location specific advantages. The cultural distance and various risks have influence on the decision whether the company chooses to enter by themselves or in a cooperative mode with a local partner. Different subsidiaries face different levels of agency problems. The desired outcome is affected by firstly having a suitable board composition that monitors the decisions made by the subsidiary and secondly having an incentive system that supports goal-oriented performance. The different roles a subsidiary can have depend on their level of global strategic value and local responsiveness. According to their roles, subsidiaries should contribute to the value creation of the multinational enterprise by sharing knowledge and resources within the networked multinational enterprise.

Key words: Headquarters–subsidiary relationship, agency theory, multinational enterprises.

Kanditutkielma

Oppiaine: Kansainvälinen liiketoiminta
Tekijä: Kai Routila
Otsikko: Ulkomaisen tytäryhtiön menestyksekäs johtaminen
Ohjaaja: KTT Johanna Raitis
Sivumäärä: 28 sivua
Päivämäärä: 24.4.2024

Tiivistelmä

Tämän kandidaatintutkielman tarkoituksena on tutkia, miten ulkomaista tytäryhtiötä johdetaan menestyksekkäästi. Useat monikansalliset yritykset koostuvat pienemmistä yhtiöistä, tytäryhtiöistä. Osalla suurimmista monikansallisista yrityksistä saattaa olla jopa yli tuhat tytäryhtiötä. Tytäryhtiöt ovat monikansallisille yrityksille erittäin arvokkaita, mutta niitä tulee johtaa oikein, jotta niistä saadaan maksimaalinen hyöty.

Tässä tutkimuksessa tarkastellaan ensin ulkomaisen tytäryhtiön perustamista ja etsitään vastauksia siihen, miksi yritys haluaa perustaa ulkomaisen tytäryhtiön. Lisäksi tarkastellaan soveltuvan kohdemaan valintaa ja mitä eri keinoja yrityksellä on asettua uuteen maahan. Toisessa osassa tarkastellaan päämies – agentti teorian näkökulmasta, miten tytäryhtiön ja pääkonttorin tavoitteet yhdenmukaistetaan. Kolmannessa osiossa tarkastellaan, mitä eri rooleja tytäryhtiöille voidaan määrätä ja miten näiden roolien puitteissa tytäryhtiöt voivat hyödyttää koko monikansallista yritystä ottaen huomioon, että monikansalliset yritykset ovat siirtyneet hajautetusta organisaatiorakenteesta verkottuneeseen rakenteeseen.

Monikansallisella yrityksellä on oltava yhtiökohtaisia vahvuuksia, joita se kykenee siirtämään sellaiseen kohteeseen, joka tarjoaa kohdespesifejä etuja. Kohdemaan kulttuurinen etäisyys ja erityyppiset riskit vaikuttavat yrityksen päätökseen asettua kohdemaahan. Vaihtoehtoina on täysi omistus uudesta tytäryhtiöstä tai osaomistus paikallisen partnerin kanssa. Eri tytäryhtiöillä on eritasoisia päämies – agentti ongelmia. Onnistuneella hallituskokoonpanolla, joka valvoo tytäryhtiön toimintaa sekä oikein soveltuvalla kompensaatiojärjestelmällä kyetään vaikuttamaan toivottuihin lopputuloksiin. Tytäryhtiölle määräytyvä rooli perustuu tytäryhtiön globaaliin strategiseen merkittävyyteen sekä sen tarpeeseen reagoida paikallisesti. Näiden roolien puitteissa tytäryhtiöiden tulee osallistua monikansallisen yrityksen arvonluontiin jakamalla tietoa ja resursseja koko verkottuneen monikansallisen yrityksen kesken.

Avainsanat: Pääkonttori – tyräyhtiö suhde, agenttiteoria, kansainväliset yritykset

TABLE OF CONTENTS

1 Introduction 7

2 Key factors in managing a foreign subsidiary successfully 9

2.1 What to consider when establishing a foreign subsidiary 9

2.2 Setting objectives and monitoring performance 13

2.3 Assigning a role within the networked MNE 17

3 Conclusions 22

References 25

LIST OF FIGURES

Figure 1. Subsidiary strategic roles and levels of agency problem 15
Figure 2. Integration-Responsiveness grid 18
Figure 3. Strategic Roles of National Subsidiaries 19

1 Introduction

This thesis will examine how to manage a foreign subsidiary successfully. The subject is important as many multinational enterprises (MNE) are made up of smaller companies, subsidiaries. Establishing a foreign subsidiary is a popular option when a firm wishes to expand overseas as a subsidiary might give the firm access to technology, knowledge, workforce, cost-effectiveness and consolidated tax returns. (Forbes 2022.) Nowadays, multinational enterprises have subsidiaries all over the world. According to Investment Monitor, in the year 2022 the approximately 6,000 biggest companies in the world had a bit over 370,000 subsidiaries out of which almost half were established in another country than the parent company itself. Almost a half of these MNEs had less than 25 subsidiaries, but there were about ten companies with even more than 1,000 subsidiaries. (Investment monitor 2022.)

MNEs have become increasingly dependent on their subsidiaries that are geographically dispersed and internally differentiated (Luo 2005b, 71) and they typically hold some of the MNEs most critical resources (Meyer et al. 2020, 538). However, subsidiaries cannot all be managed in the same way. The way they are managed will depend on their strategic importance, the capabilities they have but also the location where they are situated (Bartlett & Ghoshal 1989). There are many benefits to be gained when not only one subsidiary is managed successfully but a set of subsidiaries. Especially as MNEs have shifted from a decentralized structure to a network-based structure meaning that MNEs have an integrated worldwide strategy with interdependent resources and activities that are globally distributed (Malnight 1996, 43). Therefore, the main research question for this thesis is presented below:

- *How to successfully manage a foreign subsidiary?*

To answer the main research question, I have determined three sub-questions which are presented below:

1. *What are the key factors to consider when establishing a foreign subsidiary?*
2. *How to align the goals and motives of the foreign subsidiary with those of the headquarters?*
3. *What roles subsidiaries play in the networked MNE?*

This thesis will have a structure of three parts following the sub-questions. The main research question will be answered in conclusions. First, we need to understand why firms want to establish a foreign subsidiary via a foreign direct investment (FDI) as these investments are usually substantial and they might take many years before yielding any profits (Strange 2018, 1229). Also, we need to understand why they choose certain locations out of all the possibilities. Especially because different countries are competing against each other to have firms invest in their countries (Epstein 2019). Then there is still to decide what the most suitable mode of entry is and whether the firm is establishing a subsidiary itself or in cooperation with a partner.

Once the decision to establish a foreign subsidiary has been made, the firm needs to set objectives to the subsidiary, the strategy to achieve those objectives and means to monitor performance. To do that, firms use corporate governance systems. Corporate governance is also used to direct globally dispersed businesses, and distribute power, rights, and responsibilities to subsidiaries around the world. (Luo 2005a, 2.) Especially, we need to understand how to monitor and verify that the subsidiary is acting in a manner that the parent company wants to.

Lastly, MNEs typically have more than just one subsidiary. The set of subsidiaries makes a networked MNE. Within the MNE, subsidiaries should be assigned different roles in fulfilling the global objectives of the MNE (Bartlett & Ghoshal 1989). Traditionally, the MNE has been the prime source of resources to the subsidiaries, but the situation has changed. Resources, such as knowledge, should flow within the MNE from the headquarters to subsidiaries and vice versa, but also from one subsidiary to another. Knowledge is valuable and the value depends on the subsidiaries strategic mission and its location. (Ambos et al. 2006, 308.) Therefore, this thesis will examine the different roles subsidiaries should be assigned and how different subsidiaries can benefit the networked MNE.

2 Key factors in managing a foreign subsidiary successfully

2.1 What to consider when establishing a foreign subsidiary

To understand the key factors related to firms expanding overseas, three questions will be used: why, where and how. The why is concerned with the motive of why a firm would want to invest overseas and what the benefits are when doing so. The where answers to the selection of a location in which the firm should invest. The how comes after making the decision of investing and having found the correct location then the firm will decide on the most suitable mode of entry. We will now find answers to these questions.

First, making a foreign direct investment (FDI) is a strategic choice that is made over other alternatives, such as exporting and licensing. These investments might take many years before yielding any positive returns and they require substantial resource commitments, not only financial, but also entrepreneurial, managerial, and knowledge assets. (Strange 2018, 1229.) However, FDIs are the most powerful method to enter a foreign market. By making FDIs the firm can generate the highest returns from foreign markets. Also, via FDIs the firm can maintain the most direct and powerful influence on how foreign operations are carried out. (Welch et al. 2007, 317.)

Dunning and Lundan (2008, 67-68) have introduced to the academic literature their four seeking-motives that firms have when making FDIs: natural resources, markets, efficiency, and strategic assets. It is worth noticing that a company making an FDI might be combining the characteristics of two or even more of the before mentioned categories. Usually, firms begin their international activities by seeking new resources or markets and once they get experience in international activities, they might start seeking new means of efficiency or strategic assets to improve their competitive position. (Dunning & Lundan 2008, 67-68.) According to Cuervo-Caruzza and Narula (2015) the world has changed since these four motives and further research should be made to have a more comprehensive list. However, they add that Dunning’s four motives offer a good toolkit to be used with other frameworks. The strength of these motives is that they simplify a complex issue. (Cuervo-Caruzza & Narula 2015, 11.)

There are many theories of the multinational enterprise and foreign direct investments. Strange (2018, 1230-1231) has listed five traditional theories that are market power theory, internalization theory, transaction cost theory, evolutionary theory and the eclectic paradigm. All these five strategies are trying to explain why a firm would make an investment overseas over other alternatives and thus become a multinational enterprise. According to Strange (2018, 1231-1232) there are some similarities in each theory and some differences too. Mostly the differences occur with the so called firm specific advantages (FSA). Market power theory, evolutionary theory and the eclectic paradigm are assuming firms with FSAs usually invest overseas due to an asset-exploiting rationale as opposed to the transaction cost theory and internalization theory, which assume that the FSAs are not a prerequisite to become an MNE. Transaction cost theory and internalization theory assume that advantages from the internalization itself are sufficient to make the FDI. (Strange 2018, 1231-1232.)

Dunning's eclectic paradigm has been the most citated theory amongst scholars (Paul & Feliciano-Cestero 2021, 803). According to Dunning there are three main points that need to be satisfied so that an FDI would occur. These are widely known as the OLI-framework. The first letter O stands for ownership, which means that the firm needs to possess some competitive advantages or firm specific advantages (FSA). The L is for location, and especially a foreign location that provides some location specific advantages or country specific advantages (CSA) in comparison to the domestic alternatives. The I stands for internalization, and why the firms would want to combine the O and L advantages and engage in foreign production rather than for example licensing. (Dunning 2000, 163-164.)

The OLI-framework has been used widely as a base for other MNE-theories. The OLI-framework is not a theory *per se*, but as Dunning himself calls it, a paradigm. Dunning used it mostly to examine manufacturing firms. The OLI-framework might not be that suitable to examine new generation firms in the IT-industry such as Google as they are asset-light and often virtual in their international activities. (Paul & Feliciano-Cestero 2021, 802.)

The country where the firm makes the FDI needs to offer location advantages where the firm can benefit from its FSAs, such as brand name, unique product, technology, or marketing. The firm needs to be able to transfer its FSAs to the host nation and by doing so overcome disadvantages from being foreign. A firm might already have some presence in a host nation in the form of exporting. But if a local competitive threat would emerge in the host nation the firm needs to respond and an FDI is a solution. Also, once the firm enters the market via FDI they can benefit from the lack of import barriers, accessing local assets, local policies and tax incentives and local customers. (Welch et al. 2007, 327.)

The selected location must also offer some financial advantages compared to domestic alternatives. The firms are seeking for locations with lower costs of production and cheaper sources of inputs. It might be that the firm has first started with outsourcing activities in the host nation and later decides to make an FDI. (Welch et al. 2007, 327.) The FDI then might lead to higher revenue, lower production costs or more appealing trade costs. However, according to studies, one would think that a firm would choose a location with lower wage and tax rates, but it seems that this is not the case. One reason might be that in high wage countries, despite higher manufacturing costs, the country offers stability through infrastructure and institutions. Also, distance of the host nation from the home nation is a relevant factor; the larger the distance the higher the costs of transportation and coordination. (Nielsen et al. 2017, 68.)

Sometimes a firm needs to respond to what clients or competitors are doing. The firm might be forced to internationalize when it is sourcing another firm that is or will be present in another nation, whether the client is demanding it or to make sure the client is getting the same quality and reliability. On the other hand, a strategic move by a competitor might force the firm to make an FDI to the same location as the competitor. This is called the bandwagon effect. (Welch et al. 2007, 327.) Market demand within a specific country is another key factor of choosing a location for an FDI. This is supported by many studies, even if some studies argue that market size does not play such a crucial role. Also, the competitive conditions within a market might attract FDIs. These need to be reviewed not only on national level but also on regional level. (Nielsen et al. 2017.)

Countries are not only competing against each other for FDIs but also local states, cities and industrial clusters are in competition within a country. Studies show that industrial clusters attract FDIs, but the reason might not be the cluster itself, but other variables related to the cluster. Also, global cities are attractive for firms to make FDIs because there is an agglomeration of firms across industries and other nations but also other firms with the same nationality than the firm that is making the FDI. Especially demand driven activities such as sales, marketing and distribution are usually located in global cities. (Nielsen et al. 2017, 74.)

Once the location has been decided, there are two main entry modes, a wholly owned subsidiary (WOS) or a partnership / cooperation which is called a joint venture (JV). Wholly owned subsidiaries can be either acquired from the host nation or established as greenfield investments (Morschett et al. 2010). The selected entry mode depends on the firm's resource commitment, risk and level of control that is acceptable. The investment for a wholly owned subsidiary is higher than for a partnership, as the firm does not have a partner to share the costs with. That way the firm bears all the risk as opposed to joint ventures where the risk is limited to the share of the investments the partners have made. (Nielsen & Nielsen 2011, 186.) In addition to the investment being bigger with WOS, the investment is also seen as more irreversible. The investment is bigger as it needs to cover the acquisition, the premium, the integration costs, and the management. (Morschett et al. 2010, 61; Dikova & Brouthers 2016, 490.)

The host country plays a key role in the decision between WOS and JV. Especially in countries where the cultural distance is big a partnership is likely to be seen more appealing, as the firm can profit from the partner's knowledge (Morschett et al. 2010, 71). Choosing a JV gives the firm access to the partner's complementary resources and skills (Dikova & Brouthers 2016, 492). However, it means that the firm also needs to contribute and give the partner access to their resources and knowledge and for that reason they might prefer a WOS in order to avoid opportunism especially in insecure environments (Morschett et al. 2010, 69). If there are environmental uncertainties, a WOS is more vulnerable (Nielsen & Nielsen 2011, 186). The legal environment and regulations in the host country might even prohibit WOS or have some specific requirements for the WOS. To avoid uncertainty and being more careful and thus reduce the commitment of resources, firms might choose JV. (Morschett et al. 2010, 63.) Knowledge is another key part of selecting the entry mode. Acquisition is the most efficient way of accessing it. Also, if the firm does not have much international experience, they might use an acquisition as a substitute for that knowledge. On the other hand, if a company already has experience, they might establish a greenfield. (Dikova & Brouthers 2016, 507.)

If the MNE decides on an acquisition they need to pay special attention to the integration phase after the deal in order to achieve the goals they are looking for as the synergies expected before the acquisition need to be redeemed (Hassett et al. 2011, 109). According to Marks and Mirvis (2001, 80) even 75% of the mergers and acquisitions fail to achieve their financial and strategic goals. The MNE must decide how much autonomy it will give to the subsidiary and how much knowledge it needs to transfer to them (Angwin & Meadows 2015, 246). Also, they need to decide how much of the culture of the subsidiary they want to change, if at all. For the merger to be successful they need to mesh people, cultures and organizations. (Nahavandi & Malekzadeh 1988, 88.) The culture of the future subsidiary needs to be assessed already during the due diligence phase before the deal. But it can also be learnt in other modes of co-operation if the MNE has for example outsourced activities to the future subsidiary before the acquisition. (Cartwright & Cooper 1993, 68.)

According to the UNCTAD World Investment Report (2022) during 2018-2022 the largest MNEs have been more engaged in greenfield investments whereas the largest digital MNEs have been making more M&As. The digital MNEs require less FDIs as they need less investments to physical assets to reach overseas markets. FDIs by small and medium sized enterprises are in a declining trend. (UNCTAD 2022, xii.)

2.2 Setting objectives and monitoring performance

Agency theory has been used for a long time in management studies, but nowadays it is also being used more frequently in international business research (O’Donell 2000, 526). The agency theory allows us to understand the relationship and the corporate governance issues between the headquarters and the subsidiary more deeply, or like said by Doz and Prahalad (1991, 149) agency theory provides a good starting point to study the MNE issues.

In agency theory there are two players: the principal and the agent. In the headquarters – subsidiary relationship there is a principal-agent structure as the headquarters is delegating decision making authorities and responsibilities to the foreign subsidiary (Roth & O’Donnell 1996, 680). In this thesis the headquarters is the principal, and the subsidiary is the agent.

There are two main questions related to the agency theory. The first one is the agency problem which means that the desires and goals of the principal and the agent are not the same or they conflict, and it is expensive for the principal to verify what, in fact, the agent is doing and whether the agent is behaving as the principal would like to. (Eisenhardt 1989, 58.) If the subsidiary management makes decisions that are not aligned with the desires of the headquarters, there is an agency problem (O’Donnell 2000, 526). The second problem is risk sharing. The principal and the agent might see risks differently and their preferred actions differ because of perception of risk. (Eisenhardt 1989, 58.)

The contract between the principal and the agent is the key point in agency theory. There are two different streams exploring the agency theory. The positivist agency theory suggests that the contract should be outcome-based so that the goals would coalign with both the agent and the principal. Then the agent would most likely behave as the principal wants. The principal needs to be aware of what the agent is doing and therefore information systems need to guarantee that the principal remains well informed. The other stream is the principal-agent research, which is more mathematical and more general in its nature. This stream in comparison to the positivist agency theory tries to explain which type of contract is the most suitable in different situations. The two different types of contracts are behaviour-based and outcome-based contracts. The key point is the cost of measuring behaviour and the cost of measuring outcomes and transferring risks to the agent. (Eisenhardt 1989, 59-60.)

In the previous subchapter I pointed out the fact that the location plays a key role in the selection of the FDI. The location might be distant physically but also culturally. Agency costs for managing a culturally distant subsidiary are higher because of the information asymmetry problem as the information on-site might not be available to the parent company. It might be that the subsidiary has greater knowledge of its environment, actions, and performance than the parent has. As the cultural distance increases, the harder and more expensive it is to obtain this information. For this reason, behavioural- and outcome-based controls are difficult. (Gong 2003, 728-729.)

One way of solving this issue is to staff subsidiaries with expatriate parent country nationals to CEO, top management team and workforce levels. They might be more likely to align with the parent company’s global strategic goals and exert cultural control over the subsidiary. Especially in the beginning of the relationship expatriates improve the subsidiary’s labour productivity but the positive effect will reduce over time. By staffing expatriates, the firm is able to internalize firm-specific knowledge and skills, shared values, and goals that will reduce agency costs and make bureaucratic control less necessary. As time goes on and cultural learning happens the headquarters can apply behavioural or outcome control and the necessity for expatriates diminishes. (Gong 2003, 736-737.)

As stated already in the introduction there are thousands of firms with several subsidiaries all over the world. For the MNE to achieve superior performance, all of these subsidiaries should be viewed independently, and they should have varying strategic roles, which will then result in varying agency problems. Different subsidiaries will cause different levels of difficulty for the parent to observe and to verify what they are doing. (Kim et al. 2005, 59.) According to Birkinshaw and Morrison (1995) there are three different strategies for a subsidiary: local implementer, specialized contributor or world mandate. The three different strategies and their levels of agency problem are presented in figure 1.

Moral Hazard* (Hidden Action)		
High	**World mandate** • Relatively dependent on the headquarters and interdependent with other subsidiaries • Decision-making is partially decentralized with dispersed control system • Actions are relatively visible and verifiable • Shared values and goals	**Local implementer** • Largely independent of other subsidiaries as well as headquarters • Decision-making is highly decentralized at each subsidiary • Actions are less visible and difficult to verify • High pressure for local responsiveness
Low	**Specialized contributor** • Highly dependent on the headquarters and interdependent with other subsidiaries • Decision-making is highly centralized at the headquarters • Actions are visible and verifiable within the coordinated network • High pressure for global integration	**World mandate** • Relatively dependent on the headquarters and interdependent with other subsidiaries • Decision-making is partially decentralized with dispersed control system • Actions are relatively visible and verifiable • Shared values and goals
Adverse Selection** (Hidden Information)	Low	High

* Moral Hazard: An agency problem when the headquarters cannot observe or monitor the subsidiaries' action

** Adverse Selection: An agency problem when the headquarters cannot assess whether the subsidiaries' actions best serve the stakeholders' interests

Figure 1. Subsidiary strategic roles and levels of agency problem (Kim et al. 2005, 53)

The local implementer operates usually in a limited geographic area, usually a single country, and its products or value-adding activities are severely constrained. Its role is to adapt global products of the MNE to the local market. (Birkinshaw & Morrison 1995, 733-734.) The local implementer is independent from the headquarters and other subsidiaries and decision-making is decentralized from the headquarters to the local subsidiary managers. The local managers have been given autonomy in their decision-making. Their actions are difficult to observe and verify by the headquarters. Local implementers have the most of agency problems out of the three strategies. (Kim et al. 2005, 50-52.)

A specialized contributor has good expertise in specific functions or activities, but they are tightly coordinated with the activities of other subsidiaries. Therefore, it has a narrow set of value activities, and it is highly interdependent with affiliated subsidiaries within the MNE. (Birkinshaw & Morrison 1995, 734.) The specialized contributor is also dependent of the headquarters. The strategic responsibilities and strategic control remain in the headquarters and the decision-making is centralized to headquarters. Thus, less decision-making is needed from subsidiary managers. The subsidiaries’ activities are coordinated with the activities of other subsidiaries. This way the parent can supervise and verify the actions of the agent through the coordinated network. (Kim et al. 2005, 50.)

The world mandate has activities that are worldwide and managed by the subsidiary, not the headquarters. The subsidiary is working together with the headquarters in developing and implementing strategy. (Birkinshaw & Morrison 1995, 734-735.) Headquarters still ensure the achievement of overall corporate goals, but strategic control is dispersed to key subsidiaries throughout the organization. The subsidiary therefore takes a dominant role in a transnational strategy, but it is still part of an interdependent network system of other subsidiaries and for that reason does not have full autonomy. It is seen that a world mandate subsidiary shares common goals and values with the headquarters and that way will share local knowledge and resources with the whole MNE. A world mandate subsidiary is relatively easy for the parent to observe and verify what they are doing but still harder than a specialized contributor as worldwide activities are managed from the subsidiary and not the headquarters. (Kim et al. 2005, 52-53.)

Different corporate governance mechanisms need to be designed and selected by the headquarters for each subsidiary. The role of corporate governance mechanism such as the board of directors and compensation systems affect the behaviour of foreign subsidiary managers and might lead them to behave in a desirable way seen by the parent. (Kim et al. 2005, 60.) Accountability is also a part of corporate governance. Subsidiaries need to be accountable to the parent company, consisting of their financial reporting and transparency of decisions. The MNE must set up an accounting information reporting system within the enterprise that all subsidiaries use to achieve a firm-wide accountability. Especially an MNE with subsidiaries in various host nations face a complex challenge with many different accounting systems. Accountability will reduce monitoring costs and the evaluation of agent behaviour will be more efficient, keeping the agent in line with the parent’s objectives. (Luo 2005a, 13-14.)

The board of directors can have insider or outsider directors. The difference between the two is that outsider directors are not members of the top management team, their associates, or families, neither are they employees of the parent firm or its subsidiaries nor have they been recently in the top management team. Usually, they are involved in many boards of different firms. The insider directors have access to the information that is important to evaluate the managerial competence and strategic choices made. However, they do not put a lot of emphasis on the strategic decision process. On the other hand, the outsider directors may lack firm specific knowledge and they might not fully understand the business and its complexities, but they are keen on examining the decision-making process and the actions of managers. From an agency perspective the interests of the outsider board members are more likely to be aligned with the interests of the principal. (Kim et al. 2005, 54-55.)

As the theories of MNE, for example the internalization theory, is examining how to set up corporate governance structures that reduce costs of effecting transactions, the agency theory allows to design the corporate governance structure to align interests of managers and the shareholders. The internalization theory approach does not take sufficiently enough into account different risk preferences of managers and shareholders, and this might lead to differences in strategic objectives between the principal and the agent. From an agency perspective the costs occur before the transaction when mechanisms are crafted to reconcile differing interests between the parties. From the international theory perspective costs occur after the transaction when activities will be coordinated between the two parties. The two perspectives should be seen complementing each other as it will result in efficiency and profitability. (Filatotchev & Wright 2011, 482-483.)

The compensation system is another form of corporate governance mechanism that the parent can use to reduce agency problems and thus increase subsidiary effectiveness. Different aspects of agency problems, such as cultural distance and lateral centralization, should affect the compensation strategy components. When the senior manager of the foreign subsidiary has lower level of commitment to the headquarters more weight should be given to regional and corporate performance. There is evidence that the perceived effectiveness of the subsidiary increases when the compensation strategy is designed with an agency perspective. (Roth & O’donnell 1996, 697.)

2.3 Assigning a role within the networked MNE

As discussed earlier subsidiaries need to have different roles and strategies. Birkinshaw and Morrison (1995) introduced the three roles already mentioned before. Those roles have similarities with the model by Bartlett and Ghoshal (1998) who suggest four different roles that are placed on a so-called Integration-responsiveness (IR) framework.

Prahalad & Doz (1989) first used the IR-framework, which is a 2x2 matrix, to explain the level of global strategic coordination and the need for local responsiveness. With strategic coordination they mean central management of resource commitments across national boundaries. The goal is to recognize, build and defend long-term competitive advantages. Local responsiveness on the other hand means that decisions regarding resource commitments are made by the subsidiary to meet the local competitive or customer demands. There is pressure for global strategic coordination because of multinational customers, multinational competitors, investment intensity, technology intensity, pressure for cost reductions, universal needs and access to raw materials and energy. Regarding the local responsiveness there is pressure coming from differences in customer needs and distribution channels, availability of substitutes and need to adapt, market structures and host government demands. One MNE might have multiple subsidiaries in different businesses that are located in different sectors of the IR-framework. (Prahalad & Doz 1989, 13-21.) The IR-framework is presented in figure 2.

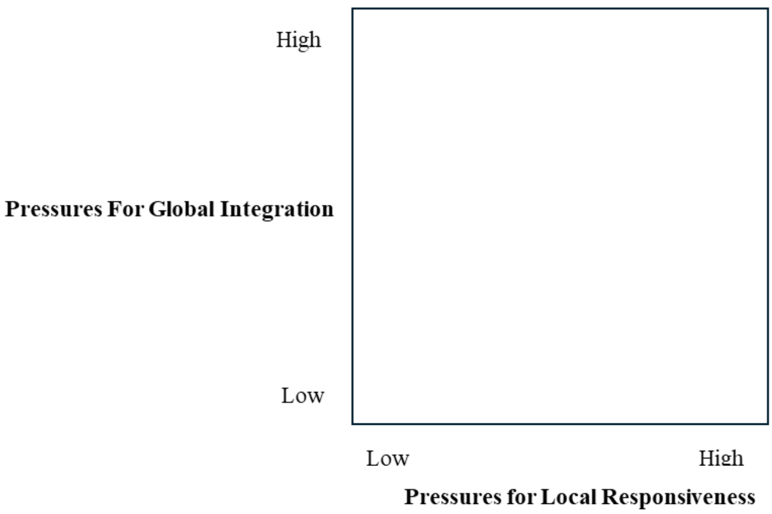

Figure 2. Integration-Responsiveness grid (adapted from Prahalad & Doz 1989)

Bartlett and Ghoshal (1989) have also used the integration responsiveness framework to determine four different roles for subsidiaries in different countries. The subsidiary’s role depends on the function it has in fulfilling the global objectives of the MNE. The four different roles are strategic leader, contributor, implementer or black hole. The model is presented in figure 3.

A strategic leader is a subsidiary with high internal competence, and it is located in a strategically important market. It must work in close cooperation with the headquarters in developing and implementing broad strategies. A strategic leader often leads a particular business on a worldwide basis. A contributor has high competence, but its strategic importance is limited. These companies should be used to support the headquarters or a strategic leader. It is also important to recognize the value of competence as otherwise for example the competent employees may leave the firm and might go to a competitor. Most subsidiaries are implementers. They possess enough competence to maintain their local operations in a nonstrategic market. The task of these companies is to implement a strategy determined elsewhere as efficiently as possible in their own markets. The last role is called the black hole, which is a role to avoid. These subsidiaries are operating in strategically important markets but with minimal capabilities. In these markets, it is important for the firm to have a strong local presence. These subsidiaries require resources to build their capabilities so that they can become strategic leaders as they should be. (Bartlett and Ghoshal 1989, 121-128.)

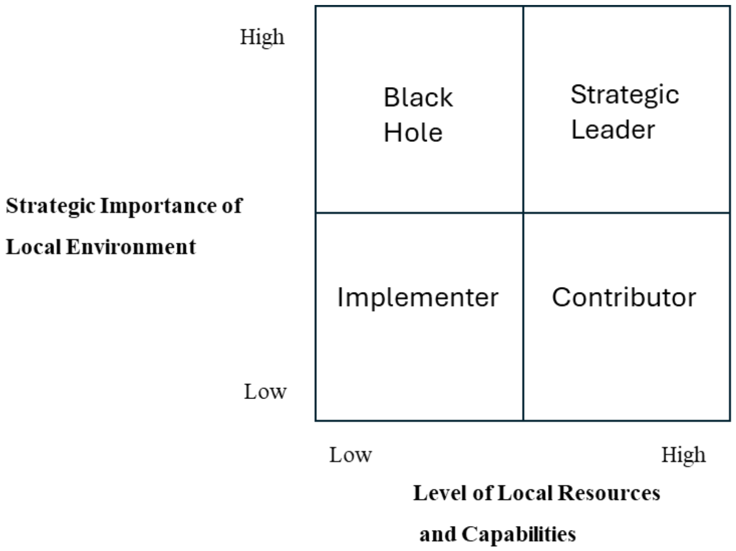

Figure 3. Strategic Roles of National Subsidiaries (Bartlett and Ghoshal 1989, 122)

Corporate managers should clearly define one of the four roles to the subsidiary and the subsidiary should also be able to identify its position in the IR-framework. Also, one needs to keep in mind that over time this role might change. Resources should be coordinated within the MNE network of subsidiaries according to the role the subsidiary has. That way the MNE can maximise its firm-specific and location-specific advantages. (Lin & Hsieh 2010, 58.)

Subsidiaries within the networked MNE should be cooperating among each other to gain new knowledge and to exploit economies of scope. They need to learn from each other. There are four dimensions where cooperation needs to happen: technological, operational, organizational and financial. Cooperation might be higher if the subsidiary is wholly owned rather than a joint venture, except if the joint venture's purpose is to acquire the partner's knowledge. (Luo 2005b, 88.) Within the MNE, capabilities can be used in other parts than in where they have originated from. The MNE can also combine resources from several subsidiaries and that way create new value. Depending on the position in the network, the subsidiary participates to contributing according to its role. (Andersson et al. 2002, 991.) It is the task of managers at the headquarters to nourish a culture of cooperation and establish systems that support it (Luo 2005b, 88).

Knowledge inflows have a positive effect on the subsidiary's performance. This is in line with the OLI-paradigm that suggests that firms expand overseas to exploit their firm specific assets, for example knowledge. Cultural distance between the parent and the subsidiary also plays a role. There is evidence that when the cultural distance is low the knowledge inflows are more likely to positively affect the subsidiary's performance. On the other hand, when the cultural distance is higher, then knowledge transfer from the parent will be lower, which then affects the subsidiary's performance. However, it is shown that when the cultural distance is high, then knowledge outflow from the subsidiary to the HQ and the MNE in total is valuable as it provides valuable host country information that can enhance the MNE's global competitiveness. (Qin et al. 2017, 87.)

The headquarters, however, need to be able to absorb new knowledge from subsidiaries. Not all knowledge is important or beneficial, and the incoming knowledge needs to be filtered. The value of the knowledge depends on the subsidiary's strategic role and economic development of the host country. While subsidiaries can produce valuable knowledge on the host country and its markets, the headquarters cannot just fully rely on that information. The headquarters need to understand the knowledge they are receiving. (Ambos et al. 2006, 306.)

Sometimes, however, the MNE might have just a limited role on subsidiary innovation. For example, a subsidiary might be solely responsible of the development of a certain product and the other subsidiaries within the MNE are not contributing to that particular R&D. Then this subsidiary plays an important and strategic role in the MNE but is not dependent of knowledge within the MNE. In fact, these subsidiaries may even have more knowledge exchange with the host environment than the MNE. (Almeida & Phene 2004, 858-859.)

It is not only the internal network of the MNE that makes a subsidiary successful, but also external networks with customers and suppliers. Developing products or activities in cooperation with a customer or a supplier will enhance the subsidiary's knowledge. It is this external embeddedness that makes a subsidiary a centre of excellence regardless of the subsidiary's size or the size of its markets. Being a centre of excellence will give the subsidiary a position within the MNE to discuss product and production process developments and the future orientation of the MNE. It is vital for the headquarters to be aware of not only the subsidiaries' capabilities but also their external networks, and the links to important customers and suppliers, as they seem to play a key role in the subsidiary's capability building. (Andersson & Forsgren 2000, 344.)

Already before the 21st century subsidiaries have been contributing to the development of firm specific advantages of MNEs and it has not been the sole concern of the parent company. Subsidiaries are performing their value-adding activity which, after all, is their role. Especially when the subsidiary has autonomy, it will influence both its initiative and contributory role. It is for the corporate system to leverage those capabilities in the global market. Then, the subsidiary's resources contribute to the MNE firm specific advantages. (Birkinshaw et al. 1998, 235-236.)

The subsidiary requires a certain level of decision-making autonomy to enhance its capabilities. Subsidiary managers need to develop their capabilities and new opportunities need to be sought out in the fields where the subsidiary has existing strengths and are aligned with the MNE's goals. This autonomy must be earned from the headquarters with a strong track record and good relations with the headquarters. (Birkinshaw & Hood 1998, 792.) Also, from an agency perspective, when autonomy increases, headquarters would use less monitoring. Hence, with increased autonomy, costs and difficulties associated to monitoring will reduce. (O'Donnell 2000, 540-541.)

3 Conclusions

The main objective of this thesis was to examine how to successfully manage a foreign subsidiary. Three sub-questions have been used in helping to find the answer to that question. The first part was to understand why, where and how a MNE would establish a foreign subsidiary. The second part was to understand, with the help of agency theory, how to align the goals and motives of the subsidiary with those of the headquarters. The third part was to understand different roles subsidiaries can have and how the subsidiaries should be managed, not only individually but as a network of subsidiaries to both enhance the performance of the MNE but also of the subsidiary itself.

As this study shows, there are multiple theories trying to explain the phenomenon behind firms becoming MNEs by establishing subsidiaries worldwide. What all the theories have in common is that by making FDIs the firm will have financial benefits, increase efficiency, or gain new knowledge capabilities. I chose to proceed with Dunning's eclectic paradigm and the OLI-framework as it is the most citated and widely known. As stated earlier in the study, the firm needs to possess some firm-specific advantages that it can transfer to a suitable location that provides location specific advantages, and by doing so the firm can overcome the disadvantages of being foreign. Also, one needs to keep in mind that a FDI is always a strategic choice made over other alternatives such as exporting or licensing.

Once the firm has found a suitable location and decides to enter the market, it must decide on the entry mode. There are two main ways, a wholly owned subsidiary, or a joint venture with a partner. Subsidiaries can be acquired or established as greenfields. Risks associated and cultural distance play a key role in the decision. FDIs are substantial financial commitments and risk can be diminished by entering in a joint venture. With this entry mode the firm can also benefit from the partner's local knowledge. However, there is then the problem of opportunism. The cultural distance can also have a remarkable impact on the entry mode selection. When cultural distance is higher the firm might favour partnership modes.

Agency theory provides a valuable platform to examine how to set up corporate governance in the subsidiary, so that the headquarters can trust the subsidiary is performing as it is intended to. The different roles subsidiaries can have will affect the levels of agency problems headquarters will face with subsidiaries. Having a suitable board composition monitoring decisions made by the subsidiaries and having an incentive system supporting goal-oriented performance will affect on the desired outcomes. Using parent company expatriates after establishing a subsidiary will most likely affect the subsidiary to perform as the headquarters wants. However, it is shown that the value of expatriates will diminish over time and then there will be no need for them.

The role a subsidiary is mandated depends on the level of global strategic value and local responsiveness. Most subsidiaries are local implementers, and their function is to execute the strategy ordered from the headquarters and fulfil the narrow task they are given. Contributors have high capabilities, but their strategic importance is low, their task is to contribute to the MNE through the network. World mandates or strategic leaders are the most important ones. They have high competence and high strategic importance. They are leading a certain business or product line worldwide. Some subsidiaries fall into black holes which is a state to avoid. MNE's need to find solutions to develop subsidiaries by allocating resources so that they climb out from the black hole and become strategic leaders, as they should be.

Flow of knowledge within the MNE is crucial. According to the OLI-paradigm knowledge is transferred from the parent to a subsidiary in the form of FSAs so that an FDI would make sense. However, nowadays, we know that it might even be the subsidiary that is creating FSAs or subsidiary specific advantages. A subsidiary can become a centre of excellence within an MNE. The external network of the subsidiary contributes vastly in developing the capabilities of the subsidiary. The MNE headquarters need to establish knowledge sharing systems within the MNE so that valuable knowledge is disseminated all over the MNE. They also need to nourish a culture where knowledge is shared openly instead of making subsidiaries fiercely compete against each other.

Subsidiaries need to be given sufficiently autonomy, so that they can also develop capabilities. As stated already in the introduction, subsidiaries hold some of the most valuable knowledge and capabilities within the MNE. This study shows that initiative will increase when there is autonomy. Subsidiaries also need autonomy to develop and create capabilities and products with their own external networks, such as their customers and suppliers. That way they can create something new that can be shared across the MNE.

This thesis can be used as a theoretical platform in a master's thesis to examine the management of one and many foreign subsidiaries within a case company. First, it should be determined what the FSAs of the case company are along with the location specific advantages in the countries where they have subsidiaries. It would also be interesting to know the motives the company had, when they made the decision on the entry mode and how well the decision fits with the theories. Secondly, the company's corporate governance structure should be examined as to how well it supports the monitoring of the subsidiary. Thirdly, the different subsidiaries the case company has should be placed in the IR-framework. Finally, it should be researched how the subsidiaries contribute, according to their roles, to the overall case company performance and how knowledge is transferred within the company and what type of dissemination systems are used. The master's thesis should bring empirical evidence to this literature review.

References

Almeida, P. – Phene, A. (2004) Subsidiaries and knowledge creation: the influence of the MNC and host country on innovation. *Strategic management journal*, Vol 25 (8–9), 847–864.

Ambos, T. C. – Ambos, B. – Schlegelmilch, B. B. (2006) Learning from foreign subsidiaries: An empirical investigation of headquarters' benefits from reverse knowledge transfers. *International business review*, Vol 15 (3), 294–312.

Andersson, U. – Forsgren, M. (2000) In search of centres of excellence: network embeddedness and subsidiary roles in multinational corporations. *Management International Review*, Vol 40 (4), 329-350.

Andersson, U. – Forsgren, M. – Holm, U. (2002) The strategic impact of external networks: subsidiary performance and competence development in the multinational corporation. *Strategic management journal*, Vol 23 (11), 979–996.

Angwin, D. N. – Meadows, M. (2015) New Integration Strategies for Post-Acquisition Management. *Long range planning*, Vol 48 (4), 235–251.

Bartlett, C. A. – Ghoshal, S. (1998) *Managing across borders: the transnational solution*. 2nd ed. Harvard Business School Press, Boston, MA.

Birkinshaw, J. – Hood, N. (1998) Multinational Subsidiary Evolution: Capability and Charter Change in Foreign-Owned Subsidiary Companies. *The Academy of Management review*, Vol 23 (4), 773–795.

Birkinshaw, J. – Hood, N. – Jonsson, S. (1998) Building firm-specific advantages in multinational corporations: the role of subsidiary initiative. *Strategic management journal*, Vol 19 (3), 221–242.

Birkinshaw, J. – Morrison, A. J. (1995) Configurations of Strategy and Structure in Subsidiaries of Multinational Corporations. *Journal of international business studies*, Vol 26 (4), 729–753.

Cartwright, S. – Cooper, C. L. (1993) The role of culture compatibility in successful organizational marriage. *Academy of Management perspectives*, Vol 7 (2), 57–70.

Cuervo-Cazurra, A. – Narula, R. (2015) A set of motives to unite them all?: Revisiting the principles and typology of internationalization motives. *Multinational business review*, Vol 23 (1), 2–14.

Dikova, D. – Brouthers, K. (2016) International Establishment Mode Choice: Past, Present and Future. *Management international review*, Vol 56 (4), 489–530.

Doz, Y. L. – Prahalad, C. K. (1991) Managing DMNCs: A search for a new paradigm. *Strategic management journal*, Vol 12 (S1), 145–164.

Dunning, J. H. (2000) The eclectic paradigm as an envelope for economic and business theories of MNE activity. *International business review,* Vol 9 (2), 163–190.

Dunning, J. H. – Lundan, S. M. (2008) *Multinational enterprises and the global economy*. 2nd ed. Edward Elgar, Cheltenham.

Eisenhardt, K. M. (1989) Agency Theory: An Assessment and Review. *The Academy of Management review*, Vol 14 (1), 57–74.

Epstein, G. (2019) *The role and control of multinational corporations in the world economy*. The handbook of globalization. 3rd ed. (pp. 165-177). Edward Elgar Publishing.

Feliciano-Cestero, M. M. – Ameen, N. – Kotabe, M. – Paul, J. – Signoret, M. (2023) Is digital transformation threatened? A systematic literature review of the factors influencing firms' digital transformation and internationalization. *Journal of business research*. Vol 157, 113546.

Filatotchev, I. – Wright, M. (2011) Agency Perspectives on Corporate Governance of Multinational Enterprises. *Journal of management studies*, Vol 48 (2), 471–486.

Forbes 1.4.2022 Three Keys To Success In The Establishment And Management Of Subsidiary Companies. <https://www.forbes.com/sites/forbesbusinessdevelopmentcouncil/2022/04/01/three-keys-to-success-in-the-establishment-and-management-of-subsidiary-companies/?sh=e333eb0678b6>, retrieved 22.3.2024.

Gong, Y. (2003) Subsidiary Staffing in Multinational Enterprises: Agency, Resources, and Performance. *Academy of Management journal*, Vol 46 (6), 728–739.

Hassett, M. – Räikkönen, M. – Rantala, T. (2011) *M&A as a strategic option : from opportunities to new business creation*. Teknologiainfo Teknova, Helsinki.

Investment monitor 14.3.2022 Where do the world's top companies have subsidiaries? < https://www.investmentmonitor.ai/features/where-do-the-worlds-top-companies-have-subsidiaries/>, retrieved 8.3.2024.

Kim, B. – Prescott, J. E. – Kim, S. M. (2005) Differentiated governance of foreign subsidiaries in transnational corporations: an agency theory perspective. *Journal of international management*, Vol 11 (1), 43–66.

Lin, S.-L. – Hsieh, A.-T. (2010) International strategy implementation: Roles of subsidiaries, operational capabilities, and procedural justice. *Journal of business research*, Vol 63 (1), 52–59.

Luo, Y. (2005a) Corporate governance and accountability in multinational enterprises: Concepts and agenda. *Journal of international management*, Vol 11 (1), 1–18.

Luo, Y. (2005b) Toward coopetition within a multinational enterprise: a perspective from foreign subsidiaries. *Journal of world business*, Vol] 40 (1), 71–90.

Malnight, T. W. (1996) The Transition from Decentralized to Network-Based MNC Structures: An Evolutionary Perspective. *Journal of international business studies,* Vol 27 (1), 43–65.

Marks, M. L. – Mirvis, P.H. – Brajkovich, L. F. (2001) Making Mergers and Acquisitions Work: Strategic and Psychological Preparation [and Executive Commentary]. *Academy of Management perspectives*, Vol 15 (2), 80–94.

Meyer, K. E. – Li, C. – Schotter, A. P. J. (2020) Managing the MNE subsidiary: Advancing a multi-level and dynamic research agenda. *Journal of international business studies*, Vol 51 (4), 538–576.

Morschett, D. – Schramm-Klein, H. – Swoboda, B. (2010) Decades of research on market entry modes: What do we really know about external antecedents of entry mode choice? *Journal of international management*, Vol 16 (1), 60–77.

Nahavandi, A. – Malekzadeh, A. R. (1988) Acculturation in Mergers and Acquisitions. *The Academy of Management review*. Vol 13 (1), 79–90.

Nielsen, B. B. – Asmussen, C. G. – Weatherall, C. D. (2017) The location choice of foreign direct investments: Empirical evidence and methodological challenges. *Journal of world business*, Vol 52 (1), 62–82.

Nielsen, B. B. – Nielsen, S. (2011) The role of top management team international orientation in international strategic decision-making: The choice of foreign entry mode. *Journal of world business*, Vol 46 (2), 185–193.

O’Donnell, S. W. (2000) Managing foreign subsidiaries: agents of headquarters, or an interdependent network? *Strategic management journal*, Vol 21 (5), 525–548.

Paul, J. – Feliciano-Cestero, M. M. (2021) Five decades of research on foreign direct investment by MNEs: An overview and research agenda. *Journal of business research*, Vol 124, 800–812.

Prahalad, C. K. – Doz, Y. L. (1999) *The multinational mission: balancing local demands and global vision*. Pbk ed. Free Press, New York (NY).

Qin, C. – Wang, Y. – Ramburuth, P. (2017) The impact of knowledge transfer on MNC subsidiary performance: does cultural distance matter? *Knowledge management research & practice*, Vol 15 (1), 78–89.

Roth, K. – O’Donnell, S. (1996) Foreign Subsidiary Compensation Strategy: An Agency Theory Perspective. *Academy of Management journal*, Vol 39 (3), 678–703.

Strange, R. (2018) Corporate ownership and the theory of the multinational enterprise. *International business review*, Vol 27 (6), 1229–1237.

Welch, Lawrence - Benito, Gabriel R. G. - Petersen, Bent (2007) *Foreign Operations Methods*. Chapter 10, pp. 315-358. Edward Elgar, Cheltemham.

World Investment Report 2022 (2022) United Nations Conference on Trade and Development, New York.