Putting parent-subsidiary relationships right: Lessons from Japanese corporate groups

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A s companies grow in size and diversify their operations either in domestic markets or overseas, the number of subsidiaries tends to increase and the structures of the companies become more complex. Nowhere is this trend more visible than in the case of Japanese corporate groups, a majority of which in 2014 were reported to have 50 or more subsidiaries each. Among the largest corporates, Sony had 1,240 subsidiaries, Hitachi 1,008, NTT 917, Softbank 796, ORIX 766 and Dentsu 707.

Effective leadership is always a challenge, but managing subsidiaries comes with additional complications. Subsidiaries operate in the shadow of the larger parent organisation and corporate management needs to address both the parent organisation’s primary mission and the subsidiaries’ goals. Governance, reporting and employee needs and motivation must also be balanced across the subsidiaries. All in all, having a multitude of subsidiaries creates a daunting task of coordinating masses of activities across the organisation.

How do Japanese corporate groups manage their subsidiaries?

By Akira Mitsumasu

The control and coordination of subsidiaries has become increasingly relevant in Japan today where, as pointed out by Miyajima and Aoki, we are witnessing an increasing number of cases of information asymmetries between the corporate head office and its many layers of internal organisations and subsidiaries. Meanwhile there has been a move toward enforced legal responsibility of corporate board members. Statutes protecting shareholders now mandate that management and boards ensure the appropriateness of activities across the organisation. Negligence in monitoring obligations can lead to litigation from shareholders. This shift begs the question: How can a Japanese corporation effectively control, coordinate and manage its subsidiary businesses across the organisation?
Parent-subsidiary relationships

It is useful to identify and classify the different types of parent-subsidiary relationships that exist, and to treat them separately rather than generalising them as homogenous. Through a series of interviews and discussions with five large corporate groups in Japan, I have constructed a conceptual classification based on the dependency relationship between the parent company and its subsidiary, which may be unilateral or mutual. The relationship is unilateral when the parent depends solely on its subsidiary for production inputs, or when the subsidiary depends on its parent as the only client and source of revenue. It is mutual when both the parent and the subsidiary depend on each other. They may trade either internally within the group, externally with outside clients, or engage in both. Figure 1 illustrates how the parent-subsidiary relationships can be classified into four main categories.

**External/Group**

**Internal/Group**

**Subsidiary**

**External/Market**

**PARENT-SUBSIDIARY MATRIX**

**FIGURE 1**

**UNILATERAL DEPENDENCE (TYPE U)**

A subsidiary belonging to this type depends on its parent as its main trading partner (client) and source of revenue. The subsidiary usually has expertise in one area that contributes to the larger product or service value chain of the parent. The parent company, however, regards the subsidiary as one of many trading partners (suppliers) in the market, and cherry picks between using the subsidiary and market for favourable production knowledge within the group and acquiring knowledge and new technologies that are accessible through working with external clients. Lock-in and inertia may arise when switching costs are high, and appropriate monitoring is needed to root out inefficiencies. Mutual dependence demands it necessary for the parent and subsidiary to coordinate regularly. Decision-making may be more centralised for Type M relationships.

**MUTUAL DEPENDENCE (TYPE M)**

A subsidiary in this quadrant sells its goods and services primarily to its parent company. The parent too is highly dependent on the goods and services its subsidiary provides, and may often exert control over decision making even on matters concerning day-to-day operations. Having such a subsidiary helps to enhance a firm’s specific specialisation whilst also reducing labour costs and thereby facilitating cost competition. Mutual dependence is often inevitable when there are no other suppliers in the market that can substitute the functions performed by the subsidiary, or when there are concerns of proprietary technology being copied or imitated.

Of the companies that I have interviewed in Japan, many have subsidiaries that fall into the Type M category. One example is the Japanese electronics company, Sharp. Between 2005 and 2009, when many television manufacturers such as Sony, Samsung, Philips and LG began to outsource their LCD panel production to allow for expansion in a growing overseas market, Sharp continued to invest in and focus on using its in-house produced LCDs, which the company believed to be technologically advanced and hence crucial to its product differentiation strategy. The Type M subsidiary may need to balance building firm-specific production knowledge within the group and acquiring knowledge and new technologies that are accessible through working with external clients. Lock-in and inertia may arise when switching costs are high, and appropriate monitoring is needed to root out inefficiencies. Mutual dependence demands it necessary for the parent and subsidiary to coordinate regularly. Decision-making may be more centralised for Type M relationships.

**DUAL FOCUSED (TYPE D)**

A Type D subsidiary sells its goods and services mainly to external clients in addition to its parent company. Between 2013 and 2016, Panasonic shifted its white goods subsidiaries from Type M to Type D as it expanded into the business-to-business segment using its nanoe generator technology (using nano-sized electrostatic atomised water particles) which had, until then, been used in many of Panasonic’s products such as refrigerators, washing machines and air conditioners. Under the Type D model, the parent company, which is highly dependent on its subsidiary’s output, may want to exert control over its subsidiary, and this may lead to a conflict of interest. For example, a subsidiary may wish to mobilise its resources to expand sales outside the corporate group, but its parent company may wish to limit its subsidiary to its external sales and focus its limited resources on the internal supply chain. Managers may be transferred or seconded from the parent to such subsidiaries to act as effective coordinators and mediators.

**INDEPENDENT SUBSIDIARY (TYPE I)**

A subsidiary belonging to this type sells its goods and services mainly to external clients. The parent too is not dependent on the subsidiary’s function and sees it as a separate revenue generating business within the corporate group’s portfolio. A subsidiary may initially be established as Type M, performing specific functions within the production value chain of the parent’s core business, such as manufacturing a certain component or performing logistic functions that support the corporate group’s supply chain. As the subsidiary gains experience and expertise in servicing its parent company, it gradually develops competencies that could be applied to other production settings with external clients. The subsidiary may eventually become a core business segment within the corporate group, and make substantial contributions to consolidated revenue. This was the path that Hitachi Transport System has taken. It began as a Type M subsidiary offering excellent logistics solutions and gradually evolved over time into a successful Type I subsidiary that provides third-party logistics and other services to many external clients. At Hitachi, better performing subsidiaries are granted more discretion over decision making and hence have more incentive to perform well. A Type I subsidiary requires little control and coordination. However, the parent company may exert control when performance drops.

Using the parent-subsidiary typology matrix, companies can identify their current parent-subsidiary relationship and adjust to better ways of coordinating business activities.

**Roadmap to creating a successful subsidiary**

Although it would be impossible to prescribe a one-size-fits-all success formula that works for every corporation and subsidiary, it is possible to draw some general implications that can be applied towards developing mutually beneficial and sustainable parent-subsidiary relationships. The simple roadmap outlined below highlights what companies should consider when managing subsidiaries.

**IDENTIFY AND EVALUATE THE CURRENT PARENT-SUBSIDIARY RELATIONSHIP FROM THE PERSPECTIVE OF BOTH PARTIES**

The first step is to evaluate the present parent-subsidiary relationship. The role of a subsidiary as perceived by the parent may be biased, and it is only when the perspective of the subsidiary is also added that the picture becomes complete. The parent-subsidiary matrix allows both the parent and the subsidiary to identify issues from their respective perspectives, facilitate discussions and foster shared
Mutual agreement and consensus are important characteristics of Japanese corporations as they allow control and coordination to function alongside decentralisation.

### ALIGN PARENT-SUBSIDIARY RELATIONSHIP WITH STRATEGY

After having identified the subsidiary type based on existing parent subsidiary relationship, the next step is to define or redefine the role of the subsidiary so as to ensure that it is aligned with the corporate group’s strategy. A mutually agreed solution between the parent and the subsidiary may result in the role of the subsidiary remaining unchanged, or in the subsidiary shifting from one type to another.

A key part of this process is to recognise and evaluate appropriately the capabilities of the subsidiary. As pointed out by Birkinshaw and Morrison, corporations as they allow control and coordination to function alongside decentralisation.

### REACHING MUTUAL CONSENSUS

#### Parent Company

It is cheaper to procure from the market because the product has become commoditised and commoditisation. But doing so will reduce operations of its subsidiary and will incur losses which the parent will have to cover.

**Possible Consensus**: Parent to transfer skills to the subsidiary to help improve productivity so that the subsidiary could gradually shift to Type D. Subsidiary to strive to be competitive in the market. If improvements are not made within an agreed time frame, the parent will close down the subsidiary or use its resources for production in another business division.

**Dependencies on inputs from the subsidiary and hence merits centripetal pressure. The parent however also benefits from economies of scale its subsidiary brings through business with external clients.**

**Possible Consensus**: Give priority to the parent’s product, as the corporate group’s core growth driver business.

**The subsidiary provides highly commoditised products that cannot be procured from the market. Hence it is not easy to determine transaction price for there is no market price to allow for comparison. The business unit is profitable, so there is little incentive to stretch its subsidiary’s targets.**

**Possible Consensus**: Use non-financial key performance indicators to monitor and motivate performance, as well as monitor the subsidiary’s procurement costs.

**Parent noticed that multiple business subsidiaries are developing and producing similar products individually.** Profitable with relatively high degree of autonomy. Becoming industry leaders in their own field.

**Possible Consensus**: Combine multiple businesses and rebrand the consolidate group as a fully integrated solutions provider. Decision rights to the subsidiary will be contingent upon performance.

### TAILOR CONTROL AND COORDINATION SYSTEMS AND MONITOR CHANGES

After having identified the subsidiary type, and mutually agreeing on the role and commitment of the subsidiary, the next important activity would be to tailor control and coordination systems that would best fit the parent-subsidiary setting (refer to Figure 3).

Again, there is no one-size-fits-all solution and, in reality, many activities often entail trade-offs. For example, a Type M (mutual dependence) subsidiary may become less competitive over time because of the absence of market discipline and availability of new external technologies. Therefore periodic evaluation is necessary to see whether assigned roles are still valid and coherent with the firm’s strategy, or whether over time, objectives have changed, demanding it necessary to revise control and coordination.

The framework thus facilitates a continuous, iterative process that helps an organisation adapt and adjust as it grows, matures and faces new market situations. **Having a ready framework to analyse complicated group management issues allows managers to have a better grasp of activities that require attention, continuous updating and refresh information, and tailor control and coordination measures based on a better understanding of evolving parent and subsidiary relationships.**

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