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Control Differentiation, Resource Sharing and Performance of Business Units

Abstract

Scholars in strategy and in international management emphasize that a fit between the context of a business unit and corporate control mechanisms enhances the performance of both the individual business unit and corporations as a whole. However, the negative implications of control differentiation across business units within a corporation have not been thoroughly studied. We use insights from procedural justice literature to assert that perceived control differentiation may be problematic when the success of a business unit depends on resource sharing with other units in a corporation. Data of 136 business units in 45 Dutch multidivisional firms support our assertion.

JEL-Classification: L22, M10.
Keywords: Control Differentiation; Performance; Procedural Justice; Resource Sharing.

1 Introduction

Most of today's large corporations are diversified. Hence, decisions on the composition and management of corporate portfolios have great practical and theoretical importance (Michel/Hambrick (1992)). In many diversified corporations there is considerable strategic variety among the business units (Calori/Johnson/Sarnin (1994)). This variety requires large companies to tailor their corporate planning and control processes to the needs of individual businesses or divisions. Chandler (1991, 48) found that corporate executives in companies such as DuPont and GE were indeed realizing the importance of differentiating their styles of control: "Most significant of all, they learned that the HQ functions varied with the characteristics of the industries in which they operated. Therefore, the production and distribution of different types of products or services required different types of planning and control systems." A great many researchers share these observations, all of which highlight the importance of differentiating the corporate planning and control processes to accommodate for differences in business unit, industry, or country characteristics (Bartlett/Ghoshal (1989); Gupta (1987); Govindarajan/Fisher (1990); Haspeslagh (1982); Lorange (1993); Nohria/Ghoshal (1994); O'Donnell (2000)).

To the extent that differentiation induces a better fit between context and organization design (Galbraith (1973)), it may improve performance for individual busi-

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ness units as well as for corporations as a whole. However, differentiation of planning and control processes may bring about a number of problems: "The danger is that there will be jealousies, suspicions and less than 100 per cent commitment, rather than a tolerance for diversity." (Goold/Campbell (1987, 257)). In this study we are interested specifically in these reactions of subsidiary managers. We argue that the problems of control differentiation have been largely neglected in the literature on corporate planning and control processes. However, studying them is relevant, since the benefits of fit may be (partially) offset by the drawbacks of differentiation. In other words, corporate managers may succeed in tailoring their styles of control to specific subsidiary contexts, but the resulting differences in treatment may very well evoke negative reactions from subsidiary managers.

Researchers have used various theoretical perspectives to study control practices in multidivisional corporations. For example, contingency and agency theory are helpful in determining the appropriate control style in particular contexts. However, the explanation of reactions of subsidiary managers to differences in control styles across subsidiaries requires a different theoretical perspective. In this study, we apply insights from procedural justice theory (Lind/Tyler (1988)) to shed new light on the consequences of control differentiation. Procedural justice theory holds that fair decision-making procedures are important to people because they signal respect and the belief that their interests will be met (Lind/Tyler (1988)). Likewise, when people perceive procedures as unfair, the procedures will trigger negative reactions in those affected by the outcomes of these procedures. In organizational settings, these reactions include a lack of cooperation by those involved in and affected by the decision-making procedures. Similarly, the quality of decisions and their implementation is at stake when the people involved believe the procedures to be unfair (Kim/Mauborgne (1998)).

Although procedural justice concepts have not yet been linked to the issue of control differentiation, some researchers claim that inconsistent procedures in general (Leventhal (1980)), and across business units in particular (Kim/Mauborgne (1991); Taggart (1997)), increase the likelihood of unfairness perceptions. Hence, corporate control differentiation triggers negative reactions in subsidiary managers through its effects on fairness perceptions. We argue that these negative reactions affect subsidiary performance, especially under conditions that require a cooperative atmosphere.

Notably, we claim that degree of interunit resource sharing plays an important moderating role in the relationship between control differentiation and subsidiary performance. Data from a sample of 136 business units in Dutch corporations support our arguments.

2 Background

Procedural justice theory holds that people are sensitive to the fairness of decision-making processes rather than merely to the outcome of the processes that affect them (Leventhal (1980); Lind/Tyler (1988)). Likewise, individuals may more easily accept unfavorable outcomes of decisions if they perceive the procedures used to arrive at those decisions as being just (Kim/Mauborgne (1998)). Originally studied in legal and judicial settings (Thibaut/Walker (1975)), the concept of procedural justice has now found its way in a variety of disciplines

and has been applied to a variety of decision settings, including organizational ones such as budget allocation (Libby (1999)) and pay raise decisions (Folger/Konovsky (1989)). Attempts have been made to develop theoretical insights that can be generalized across different settings. The study of Lind and Tyler (1988) is well known. Based on a thorough review of the literature, these authors describe two theoretical perspectives that explain the effects of procedural fairness perceptions. According to the first perspective, concerns over fair procedures are mainly based on self-interest of egoistic human beings. Procedures are considered fair to the extent that the outcomes of these procedures promise to meet the short- or long-term interests of these persons. The second perspective emphasizes group values and group identification. According to this perspective, group or organizational membership is important to fulfill people's needs for self-identity, self-worth, acceptance, and respect (Konovsky/Brockner (1993)). Fair procedures strengthen these needs and increase people's loyalty and commitment to the group or organization to which they belong (Lind/Tyler (1988)). Together, these perspectives explain much of how people react to unfair procedures.

In organizational settings, perceptions of unfairness may lead to frustration, noncompliance with rules and procedures, negative evaluations of superiors, distrust, low quality of work life, sabotage, low commitment to the organization, and poor performance (Cropanzano/Randall (1993); Folger/Konovsky (1989); Kim/Mauborgne (1998); Lind/Tyler (1988)).

2.1 Procedural fairness in headquarters-subsidiary relationships

Although applying procedural justice literature to gain insights in the control of business units is relatively new, studies in related areas set the stage. Particularly relevant in the context of our study is the work of Kim and Mauborgne (1991, 1993a, 1993b, 1995, 1996), who study strategic planning processes in multinational companies. An implication of their work is that fairness perceptions affect the degree of top-down/bottom-up cooperation, which is considered so important in the strategic decision making of today's large and complex corporations (Burgelman (1983); Lorange (1993); Mintzberg (1990); Quinn (1980)). Identification with the organization and trust in the intentions of corporate-level management enhance the willingness of subsidiary managers not only to comply with organizational rules and decisions, but also to invest time and energy beyond that what is expected of them. This extra-role behavior or voluntary cooperation (Kim/Mauborgne (1996)) is important, both for strategy formulation and implementation. At best, unfair procedures may lead to in-role behavior, or behavior in line with, but not exceeding formal role requirements (Kim/Mauborgne (1996)). However, it is more likely to lead to a lack of cooperation and unwillingness to share information (Kim/Mauborgne (1998); Korsgaard/Schweiger/Sapienza (1995)). Likewise, since both strategy formulation and implementation are important for success (Govindarajan (1988); Hill (1994); Michel/Hambrick (1992)), unfairness perceptions place performance at stake.

2.2 What determines fairness perceptions?

Researchers have identified a number of factors that determine perceptions of procedural justice (Folger/Konovsky (1989); Greenberg (1986); Leventhal (1980)). We

concentrate on one of these factors: inconsistencies in the procedures used across different parties in an organization. Kim and Mauborgne (1993b, 427) speak of consistency as "a signal that a level playing field exists across subsidiary units and that political favoritism does not dominate the dynamics of the decision process." Therefore, in line with the self-interest perspective of procedural justice, consistent procedures provide individuals with a clear structure that they can consider as protecting their interests. Moreover, individuals also base their inferences about fairness of procedures on comparison with others in the "group" (Naumann/Bennett (2000)). In line with the group-value perspective of procedural justice, consistencies across different parties within the group and equal treatment of these parties strengthens identification with the group and its values and objectives.

The extent to which procedures are consistent can also affect justice perceptions through other factors. The differences in procedures used across different parties may cause ambiguity if these parties fail to make sense of the different procedures their superiors use (Goold/Campbell (1987)). Some researchers argue that understanding and clarity of procedures, expectations, and decisions are important bedrock principles of procedural justice, which, when violated, may arouse feelings of unfairness (Kim/Mauborgne (1998)). In sum, the lower the consistency of procedures across different parties, the lower the likelihood that these procedures will be considered fair (Kim/Mauborgne (1995)).

2.3 Procedural justice and control of business units

The arguments discussed so far suggest that procedural justice is a relevant perspective for studying the effects of differences in control practices in multidivisional firms. Although many experts have propagated the importance of control differentiation to accommodate for differences in business unit strategic contexts (Chandler (1991); Gupta (1987); Lorange (1993); Nohria/Ghoshal (1994)), the negative consequences remain largely unrecognized. However, as discussed in the previous sections, procedural justice literature provides important new insights concerning the "interaction dynamics in head office-subsidiary decision-making dyads." (Kim/Mauborgne (1993a, 504)). In general, justice researchers use the terms process or procedure to refer to "something that is a method, manner, technique, or means by which something else is accomplished." (Cropanzano/Ambrose (2001)) To the extent that managers can perceive controls as the processes or mechanisms by which organizations ensure that subunits act in a coordinated manner to achieve organizational goals (Das (1989); Lebas/Weigenstein (1986); Ouchi (1979); Tannenbaum (1968)), differences in these processes across business units in one and the same firm may lead to perceptions of unfairness and their associated negative effects.

3 Hypotheses

In this section, we outline our arguments and summarize these in two hypotheses. Our focus is on the control arrangements that characterize headquarters-subsidiary relationships in multidivisional firms. The arrangements capture important relationships that exist between company headquarters and its subsidiaries. For example, the arrangements involve the degree of autonomy granted to an individ-

ual business unit and the nature of the criteria used to evaluate its performance. The degree to which these arrangements differ across subsidiaries within one and the same corporation is called the degree of control differentiation. In terms of the procedural justice arguments outlined in the background section, we treat control differentiation as an inconsistency in the procedures used by corporate headquarters that may give rise to unfairness perceptions. Our level of analysis is that of the business unit. Hence, control differentiation refers to subsidiary managers' perceptions of the differences that exist between the control arrangements used for their own subsidiary and the arrangements used for other subsidiaries in the same corporation.

Our first hypothesis concerns the main effect of control differentiation. In line with the procedural justice literature, we expect that perceptions of unfairness damage the trust and organizational commitment of subsidiary managers. Low levels of trust and commitment reduce the willingness of these managers to voluntarily cooperate in the formulation and implementation of important strategic decisions. Since performance is to a large extent determined by the quality of both, subsidiary performance will suffer as a result of unfairness perceptions. Hence, our first hypothesis is:

Hypothesis 1: *Perceptions of control differentiation have a negative effect on business unit performance.*

Strategic decision making in complex firms is a top-down/bottom-up process that requires interaction and cooperation between corporate and business-level managers (Lorange (1993)). However, the importance of cooperation differs across different contexts. Our second hypothesis addresses this. In diversified firms, the cooperation required in decision-making processes relies heavily on the degree to which interdependencies between business units exist. Interdependencies between business units may give rise to all kinds of synergistic advantages (Penrose (1959); Teece (1982)). However, the degree to which these synergies are actually exploited depends to a large extent on coordination efforts of corporate-level executives (St. John/Harrison (1999)). Effective sharing of resources and knowledge usually requires intensive communication and collaboration between business units and corporate executives. Although business units are generally more knowledgeable about their local circumstances, corporate executives usually have the wider view that is required to coordinate processes in which several business units are involved (Egelhoff (1988)). Consequently, planning and control processes depend heavily on the input of both levels of the firm.

Interunit resource sharing also requires joint decision making, information sharing, joint problem solving, and mutual adjustment between units. Under conditions of high interunit resource sharing, cooperation in general, and voluntary cooperation in particular, becomes especially important. Therefore, the negative effects of control differentiation become particularly evident in situations of high interunit resource sharing. Alternatively, under conditions of low interunit resource sharing, the problems associated with unfairness through control differentiation may be present, but will carry smaller weight. This notion is in line with Kim and Mauborgne (1995), who find that consistency in procedures is positively related to global learning. Moreover, they find that perceptions of fairness have a stronger effect on subsidiary performance for subsidiaries in global industries, in which cooperation among subsidiaries is relatively important, than they have for those operating in

multidomestic industries, where subsidiaries can operate somewhat autonomously (Kim/Mauborgne (1993b)). To the extent that "...social harmony or a cooperative atmosphere between the corporate center and subsidiary units will foster global learning by making the sharing of knowledge and information a 'desirable' activity..." (Kim/Mauborgne (1995, 47), their findings support our arguments, which are summarized in our second hypothesis:

Hypothesis 2: *The negative relationship between perceived control differentiation and business unit performance is amplified by the degree of inter-unit resource sharing.*

4 Methods

4.1 Sample and data collection

We conducted a study among Dutch corporations. We started with a list of all Dutch corporations listed on the Amsterdam Stock Exchange and excluded all financial corporations and corporations with less than 500 employees. We then studied annual reports and company websites to identify the business units that were located directly below headquarters. Corporations with functional structures and corporations for which the annual reports did not provide sufficient information on the organizational structure were eliminated. We also excluded the corporation if it appeared to be majority-owned by another corporation. We ended up with a selection of 614 subsidiaries from 57 corporations.

Since most of the data we needed were unavailable from archival databases, we conducted a mail survey. We sent questionnaires to the managing directors of each of the 614 subsidiaries. Out of the total of 614 questionnaires sent to business unit managing directors, 140 filled out questionnaires and returned them (i.e., a response rate of 22.8%), of which we were able to use 136 responses in this study. The 136 business units represent 45 corporations and cover industries such as manufacturing (27.2%), service (28%), printing/publishing (10.3%), trade (22.1%), and construction (12.5%). In total, our data set includes business units in 14 different countries. A total of 34 business units (25%) are located outside the Netherlands. On average, the subsidiaries employ 1596 employees.

We used many ideas from previous studies as input for developing our own questionnaire (see subsection 4.2, "Operationalization of main variables", for further details). We discussed the questionnaire at length with colleagues in strategic management and accounting research and with practitioners who held a position as managing or financial director in subsidiaries of large corporations.

We developed the questionnaire in Dutch, but translated it into German and English for foreign business units as well. We sent questionnaires in Dutch to business units located in the Netherlands and the Flemish part of Belgium. We sent German translations to business units located in Germany or Austria and English translations to business units located in all other countries. We used backward-translation techniques to account for differences in interpretation. Based on the backward translations and on the discussions with colleagues and practitioners, we made final changes to the questions.

4.2 Operationalization of main variables

Performance. Since performance data are usually not readily accessible for subsidiaries of Dutch corporations, and since we expected managers to be reluctant to share objective performance data with us, we had to rely on other measures of performance. We used Likert-type scales and asked managers to rate their subsidiary's average performance over the last two years in terms of both profitability and sales growth compared to the following benchmarks: expectations of headquarters, performance in previous years, and performance of the most direct competitor. We averaged the scores on the six items to arrive at an overall score for subsidiary performance (alpha = 0.86).

Perceived control differentiation. Although the literature provides many measures of organizational design and planning and control processes, there is no measure of perceived differentiation. We decided to use four dimensions of control that are widely used in literature. We asked subsidiary managers to indicate on a seven-point Likert scale to what extent there are differences between their subsidiary and other subsidiaries of the corporation in terms of: (a) the extent to which procedures and directives of headquarters have to be followed; (b) the autonomy subsidiaries have in relation to headquarters; (c) the way the performance of the subsidiary is evaluated by headquarters; (d) the way subsidiary managers are compensated by headquarters. We averaged the scores on the four items to create the measure for perceived control differentiation (alpha = 0.81).

Interunit resource sharing. We measured this variable through eight questionnaire items. We chose the items to include both tangible and intangible resources (Porter (1985; 1987); St. John/Harrison (1999)) and to include resource sharing in different functional areas (Gupta/Govindarajan (1986)). We asked managers of subsidiaries to indicate on a seven-point scale to what extent their subsidiary cooperates with other units in each of the following ways: (a) sharing knowledge, information, ideas, et cetera; (b) sharing technologies; (c) internal deliveries (e.g., components, products, services); (d) using common brand names; (e) sharing physical assets (e.g., machines, buildings); (f) exchanging personnel on a temporary basis; (g) collectively competing with competitors; (h) shared functions or services (e.g., purchasing, marketing, logistics). We used the average score on these items as our measure for resource sharing (alpha = 0.87).

4.3 Control variables

We included *socialization* as control variable for the extent to which we could expect to find shared values and norms. Shared values and norms can be stimulated by socialization mechanisms such as rotation of managers and corporate training programs. We expect these mechanisms to make subsidiary managers less sensitive to differences in the control styles used by their superiors. Therefore, the use of socialization mechanisms may influence our results.

We asked subsidiary managers to indicate on seven-point scales the extent to which they agreed on the following statements: (a) many managers and key staff employees in my unit come from other parts of the corporation; and (b) managers

and key staff employees in my unit often participate in training programs organized by headquarters. Together, these two items measure the use of corporate socialization mechanisms (alpha = 0.59).

We also included a measure for *network-based incentives*. We expected that network-based incentives would be an important stimulator of cooperation and therefore might be a influencing variable. In line with other studies (Gupta/Govindarajan (1986); Gupta/Govindarajan (2000)), we measured this variable as the percentage of total variable compensation that was based on the performance of a cluster or network of business units or the corporation as a whole.

We included business unit *size* because size is an indication of the resource levels a certain business unit has, and because the resource base may influence performance. We measured size as the number of people employed by the business unit (Gupta/Govindarajan (2000)).

We also decided to include industry dummies to control for industry effects. However, since we did not find industry effects and since including these dummies had no effects on our results, except for making the overall fit of the regression models worse, we excluded these dummies from our final model.

4.4 Common method bias

Like most studies on the internal control arrangements in multidivisional firms (Hill (1988)), we had to rely on key informants to obtain our data. Relying on a single key informant for every business unit should make us aware of the risk of common method bias. We dealt with this concern in a number of ways (Brouthers/Brouthers/Werner (2003); Podsakoff/MacKenzie/Lee/Podsakoff (2003)). First, we included objective measures (e.g., size) and used multiple measurement items to measure the less objective variables. Second, we approached the managing directors of the business units to ensure that the person who could be assumed to be most knowledgeable of the subject matter acted as our key informant. Third, hypothesis 2 contains an interaction effect and effects like this have been found relatively insensitive to problems of common method bias (Dooley/Fryxell (1999)). Finally, we performed a one-factor test to assess the likelihood of common method bias in our data. We included all the dependent and independent variables of interest into a single exploratory factor analysis. Because (a) more than one factor emerged from the analysis, and (b) there was no factor that explained the majority of the covariance among the measures, it is unlikely that common method bias explains our results.

5 Results

We report the results of the correlation and regression analyses in *tables 1* and *2*, respectively. Correlation coefficients show that there are significant relationships between some of our independent variables. These relationships should make us aware of potential multicollinearity in the regression models, which we assess using VIF scores. None of these scores exceeds ten, indicating that no serious multicollinearity is present.

Table 1: Descriptives and correlation matrix

	Mean	S.D.	1	2	3	4	5
1. Business unit size[a]	1596	4348					
2. Socialization	2.83	1.38	0.334***				
3. Network-based incentives[b]	18.69	20.29	0.113	0.465***			
4. Business unit performance	4.62	1.03	0.079	-0.122	-0.230**		
5. Control differentiation	2.78	1.19	-0.168†	-0.150†	-0.120	-0.018	
6. Resource sharing	3.58	1.34	0.164†	0.601***	0.450***	-0.022	-0.193*

n = 136
†: $p < 0.1$; *: $p < 0.05$; **: $p < 0.01$; ***: $p < 0.001$
[a]: Variable has been transformed (log) to achieve a more normal distribution. We report descriptive statistics for the original variable.
[b]: Variable has been transformed (square root) to achieve a more normal distribution. We report descriptive statistics for the original variable.

Table 2: Results of regression analyses

	Model 1	Model 2	Model 3
(Constant)	(....)***	(....)***	(....)***
Socialization	-0.064	-0.143	-0.167
Network-based incentives	-0.214*	-0.248*	-0.238*
Business unit size	0.124	0.126	0.137
Control differentiation		-0.019	-0.087
Resource sharing		0.152	0.178
Control differentiation x resource sharing			-0.206*
R^2	0.067	0.082	0.112
F-ratio	3.145*	2.305*	2.877*
Change in R^2		0.015	0.037
F-ratio change in R^2		1.043	5.347*

n = 136
Dependent variable is business unit performance (as reported by the business unit manager).
The table shows standardized coefficients.
*: $p < 0.05$; ***: $p < 0.001$ (one-tailed if hypothesized; two-tailed otherwise)

We use regression analysis to test our hypotheses and run three regression models with subsidiary performance as the dependent variable. Model 1 includes only the control variables. Model 2 includes the main effects of control differentiation and resource sharing as well. From this model it becomes clear that there is no significant main effect for control differentiation. This insignificant effect means that our findings do not support hypothesis 1. Model 3 includes all main effects and the interaction term. We compute the interaction term by taking the product of control differentiation and resource sharing. Following recommendations of Aiken/West (1991), we center each variable before composing the interaction term. Change statistics indicate the increase in R^2 compared with model 2. The results show that the inclusion of the interaction term improves the overall model fit. Moreover, the interaction term has a significant relationship to performance, as indicated by the significance of the regression coefficients. The sign of the regression coefficient is in line with our expectations. Hence, the results support hypothesis 2.

6 Conclusion

In this paper we set out to create new insights into the control of business units in multidivisional firms. So far, researchers have concentrated on finding the optimal control style under different contexts. The implication is that different contexts in a multidivisional corporation necessitate the adoption of different control styles by corporate headquarters management. However, in this paper we argue that such a conclusion is far from complete, because it ignores the negative effects that may be inherent in the simultaneous use of different control styles for different subsidiaries of the same corporate family.

Using procedural justice literature, we argue that control differentiation reduces business unit managers' trust in their superiors, commitment to the organization, and, consequently, the degree of voluntary cooperation they display. Our results show that control differentiation does not always hamper performance, since we do not find a significant relationship between the two variables. However, we expected the disadvantages of control differentiation to be salient, especially in situations that require high levels of voluntary cooperation. The significant moderating effect of interunit resource sharing supports this notion. Hence, in corporations where the exploitation of interrelationships between business units forms the heart of corporate strategy, adjusting the control style to subsidiary context may in fact be counterproductive.

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