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The Hesitant Transfer of Strategic Management Know-How to Foreign Wholly Owned Subsidiaries in China

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This is the second of two articles on the extent to which strategic management know-how is being transferred from foreign companies to their affiliates in China. The first article was published in *Management Research News*, Volume 25, Number 1, 2002 (Wong, Maher and Luk, 2002) and addressed international joint ventures. The current article addresses wholly owned subsidiaries. They were approached separately because of their radically different organisational structures and ownership features.

Both articles are the product of a research effort which began on-site in China in 2000. They were inspired by the growing belief among academics and professionals that only minimal strategic management knowledge was being transferred due to the reluctance of the foreign company to disclose it and the eagerness of the Chinese affiliate to receive it. As a first step, our research sought to determine what, if any, strategic management know-how is currently being transferred. If the amount is significantly less than one would ordinarily expect, we surmised that future research could be expected to address the reasons. Shortfalls might stem not only from different political, economic and cultural mindsets but also from distrust, unequal bargaining strength, and diverse objectives. The extent of control over the Chinese affiliate by the Chinese government was also considered of interest in our inquiry.

We decided that an initial study should concentrate on fundamentals. We therefore addressed the subject in terms accepted by most professionals and academicians: mission, goals, objectives, environmental analysis, strategy formulation, strategy implementation and feedback (Boyd & Reuning-Elliot, 1998). We also decided that only voluntary transfers should be addressed and not such aberrations as the piracy of intellectual property (patents, copyrights, trademarks, and trade secrets), which raise quite different considerations (Roberts & Balfour, et al., 2000; Isobe & Makino, et al., 2000).

In our conclusion, we attempt to forecast the likelihood of future transfers of strategic management know-how from foreign companies to host-country affiliates in their possible role as important on-the-scene vehicles for strategic management implementation as access to China's domestic market grows.

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Background

Deng Xiao Ping's "Open Door Policy" of 1978 is the point at which an understanding of foreign wholly owned subsidiaries and international joint ventures in China must begin. While that policy was welcomed by foreign companies as an opportunity to expand operations and increase profits, it inspired caution as well. It caused many foreign companies to view China as a paradox because of its effort to mix a free market economy with a centrally controlled, authoritarian political structure. They were aware that Western economists consider these inherently incompatible and likely to alter the conditions on which business would be typically conducted in a free market.

The Chinese, on the other hand, based their hope of economic and societal improvement on the assumption that the government can simulate a market economy while retaining a significant level of entity ownership and overall regulation. Relying on that proposition, the government has, in fact, exercised control in varying degrees over Chinese affiliates of foreign companies.

The polarity between these two positions has been widened by the fact that the Chinese domestic market has been essentially closed to foreign companies. For all practical purposes, they have been required to manufacture in China for export elsewhere. High quotas and tariffs have insured that result (*East Asia Executive Report*, 1998). Notable exceptions have been service-oriented enterprises, such as fast food and beverage outlets, and the like.

Initially, the Chinese government viewed the foreign company as both a threat and a benefit to its economic, political and societal well-being. This ambivalence accounted for the philosophy behind China's Joint Venture Law of 1979, which virtually mandated the joint venture as the mode of entry for foreign companies doing business in China. The foreign wholly owned subsidiary was not initially looked upon with favour and therefore not commonly found. Through the joint venture the government could maximise its control as a matter of organisational structure because it gives both parties equal rights to management, disclosure, loyalty, and knowledge, unless otherwise agreed upon. That is basic partnership law, but it is not true of wholly owned subsidiaries.

Mindful of such control, the Chinese government typically dictated the selection of the host country partner and the number and identify of its Chinese executives and supervisory employees. The government was quite aware that the wholly owned subsidiary was controlled entirely by the parent organisation, even though the government could condition its activities somewhat by way of regulatory restraint or empowerment. Thus, the international joint venture provided a major advantage to the government in realising its societal objectives. At the same time, it posed a serious threat to the foreign company's ability to protect its know-how and competitive edge

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vis-a-vis its competitors. That is because transfer to one's host-country affiliate may well result in further transfer by it to one's competitors, particularly when the affiliate is under the control, wholly or partially, of a sovereign nation with its inherent prerogative to do as it wishes.

Thus, government control first came to be measured in terms of the extent to which the government held an ownership interest in the Chinese affiliate (Child & Yuan, 1996). Three classifications developed in the literature: state-owned enterprise (SOEs), partially state-owned enterprises (semi-SOEs), and privately owned enterprises (non-SOEs). SOEs or semi-SOEs constituted the vast majority of those authorised by the Chinese central government to combine forces with foreign companies in a common production-oriented objective. The ownership interest was frequently held by the Peoples Liberation Army (PLA) (*Asian Wall Street Journal*, 1998). Non-SOEs were not seen in significant numbers until recently. Obviously, this classification is relevant only to international joint ventures. By definition, it has no applicability to wholly owned foreign subsidiaries, and partially owned foreign subsidiaries are not common in China at this time. In contrast, a Chinese partner in a joint venture must obviously be either a SOE, a semi-SOE or a non-SOE. However, that classification and its implications provide a clue as to how a negative attitude toward information transfers may have been engendered in the minds of foreign investors irrespective of organisational structure.

Things were about to change with a stunning announcement by Chinese President Jiang Zemin a few years ago. The customary SOE classification can now no longer be regarded as static and categorical but must be seen as a series of points on a continuum of change whose terminus is private ownership competitively selected and empowered. At the same time, the protective mindset of the foreign company with respect to the transfer of its know-how is also challenged by this new dynamic. The re-assessment that must inevitably occur is being catalysed by China's formal acceptance into the World Trade Organisation (WTO) on December 11, 2001 (*Financial Times*, December 11, 2001).

The Elimination of the SOE and the Semi-SOE

Jiang's announcement was made on September 12, 1997, at the 15th Party Congress in Beijing's Great Hall of the People. He declared that all but 1,000 of China's 300,000 state-owned enterprises (SOEs) would gradually be left to fend for themselves in favour of new business structures, which he did not specifically identify. He was motivated by the fact that SOEs, with their inherent monopolistic tendencies, inefficiency and huge unpaid debt, had left China's banking system in a shambles. He saw the introduction of competition into the market place, with its concomitant preening and conservation of resources, as the most effective remedy (Wong & Maher, et al., 1999).

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Of course, Jiang's startling announcement has yet to be fully implemented. Its progress has been predictably affected by a number of restraining factors, not the least of which is the prospect of increased unemployment, which is particularly worrisome because of China's vast, impoverished Western region (Roberts, 2000). Yet, it seems clear that China will continue to seek improvement in the organisational structure of its industries in order to make them more productive and fiscally responsible. While foreign investors view this optimistically, they are nonetheless confronted with a system that is in the tortuous process of change and one that will remain uncertain for some time to come. Their willingness to transfer their knowledge to their Chinese counterparts in that kind of environment depends upon the extent to which they can limit its further transfer to potential competitors. Their willingness will be related, at least in part, to the extent to which the Chinese government chooses to exercise control over Chinese affiliates in implementing Jiang's policy. In short, where there is considerable risk but no clearly perceived benefit, transfers are unlikely.

The Nature and Attraction of Privately Developed Know-How

Most companies are unwilling to disclose their privately developed know-how in the absence of a compelling reason. It is usually knowledge that the company has developed at great expense over long periods of time and which it regards as its "stock in trade," vital to the company's survival.

Of course, companies cannot avoid disclosing information of a technological nature because it is necessary for the manufacture or assembly of the product. That is the reason they joined forces with their Chinese affiliates in the first place. However, non-technological information is another matter. There is much less reason to disclose it because the manufacture of the product does not directly depend on it (Wong, Maher & Luk, 2002). Further, as mentioned, retention of such information can be vital to the ability of the company to preserve its competitive edge.

These differences may account for the fact that there has been some literature on the transfer of technological information but little on the transfer of non-technological information. There has been virtually none on the transfer of strategic management know-how, a type of non-technological information (Pien, Wee, & Peck, 1999).

In attempting to fill the gap, we were motivated by the generally accepted proposition that strategic management know-how is largely responsible for the success that Western companies and those that emulate them have enjoyed in recent years. As has been said, "Good strategy and good strategy-execution are the most trustworthy signs of good management" (Thompson & Strickland, 2001:4), and we might add what is thereby implied: company success. We were collaterally influenced by the fact that

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strategic management is usually the capstone course in both MBA and undergraduate curricula.

Finally, as between the parties, the foreign party is well aware that it is generally the entity with the most sought after information, whatever the type. In fact, acquiring information from the foreign partner or parent is an important reason that host-country parties enter into such arrangements in the first place (Simonin, 1999).

Interview Protocol

At the outset, we foresaw the difficulty in arranging interviews with persons of such authority, knowledge and experience as would yield reliable and sufficiently important information. To that end, we consulted with host-country contacts in academia, government and business in order to make the necessary arrangements and to identify target companies, their top management, and the scope of the interviews. It seems fair to say that the attention of the interviewees would not have been so timely achieved were it not for the reputation and visibility of those who acted on our behalf.

As a result, the authors were able to conduct all discussions on-site with either the general managers personally or their immediate representatives. We believe that the fact that they were made without interruption and with the exclusive attention of the highest level of authority within the Chinese affiliate lends a certain uniqueness to this study.

Each interview was made by pre-arrangement several weeks in advance, and each manager was advised beforehand of the scope of the interview. As a result, each was well prepared and had the relevant information readily available. Each interview ranged from one to two hours, exclusive of plant tours, and was held in the interviewee's office or conference room. When necessary to clarify a response, a focused plant visit was provided.

A standardised set of pre-conceived questions was used to acquire basic data, such as the composition of the board of directors, number of employees, type of product, company size, etc. However, the interview time was devoted primarily to the special circumstances in which each company does business within the context of its own objectives (Wong, Maher & Luk, 2002). Further, the critical questions posed, though similar for each interview, were mainly open-ended.

In the interests of optimising available interview time, the research team used a sequential, three-part question and answer approach. One author addressed organisational structure, another focused on internal strategic content and the third targeted the external strategic environment.

To promote full and free discussion and to respect the sensitivities of the interviewees, none of the sessions was taped. However, a paid research

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assistant, fluent in both Mandarin and English, was present for all interviews and was assigned the exclusive responsibility of transcribing all relevant information in the greatest possible detail. Each of the three authors also made his or her separate notes.

The Dialogues

All of the wholly owned subsidiaries are the Chinese affiliates of large foreign companies of diverse national origin. The names of the officials interviewed and their firms are not set forth herein for reasons of deference and anonymity and to encourage full and free discussion during the interviews. The Chinese affiliates are referred to herein as the food processing company, the paper manufacturing company, the plaster manufacturing company and the computer manufacturing company.

Although Hong Kong reverted to China on July 1, 1997 (Wolf, Jr., 1997), the Hong Kong owner of the computer hardware company was nonetheless considered a foreign wholly owned subsidiary because Hong Kong will be a Special Administrative Zone for fifty years. Its pre-reversion economic, commercial and cultural character will remain in effect during that time and free of Chinese sovereignty (Xinhua Newsagency, 1997).

For editorial simplicity and synthesis, the information acquired is integrated and summarised in narrative fashion.

Exhibit 1: Transfers of Strategic Management Knowledge by Company

Company Type	Nationality of Foreign Partner	Interviewee Position	Transfer Level
Plaster	Germany	Marketing Manager	Minimal
Paper	Japan	Chief Liaison Officer	Minimal
Food Processing	Thailand	General Manager	Moderate
Computer Hardware	Hong Kong	General Manager	Minimal

Source: Transfer evaluations are the authors' holistic consolidation of three factors per company: (1) content; (2) resulting organisational structure; (3) actual implementation. Evaluation range is: not evident, minimal, moderate, high and advanced.

Mission

All of the subsidiaries understood basically what they were supposed to achieve, but none had formalised its understanding in the fashion of a mission statement to which foreign practitioners and academicians are accustomed. According to Thompson and Strickland (2001), a company's mission statement should address its present business scope, i.e. "who we

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are and what we do." All of the companies tended to confuse "mission" with corporate culture, with goals and objectives, or with the principles of management. They did not seem able to indicate to any noticeable extent what they understood by "mission."

Goals and Objectives

It was clear that all of the company managers understood this strategic step and had considerable authority to define both short-term and long-term goals, the latter often under the supervision of a delegate from the parent company. Most goals were related to product quality and market share. There was also a common flow-down goal (foreign parent to Chinese affiliate) that vaguely addressed future penetration of the Chinese domestic market when conditions would permit.

All of the companies were understandably sensitive as to how they were regarded by their foreign parents, and most managers appeared to have internalised the ultimate goals of the parent company. In those instances where company facilities were toured, the authors found the company's goals quite visibly displayed in both administrative offices and manufacturing areas.

Short-term goals. Most of the companies appeared to have clear authority to establish short-term goals, typically to be achieved within a one-year time frame. They generally addressed them in terms of quality improvement, increased sales, cost and budget control, fast delivery, shorter production-cycle time, enhancing competitive edge, and expanding market share. Their short-term goals tended to be financial or strategic and were often quite specific. They seemed consistent with their limited role as cost or profit-centres at the operating level, which, of course, is generally the lowest level in an organisational hierarchy.

Long-term goals. Most long-term goals fell within a five-year time frame and were reviewed periodically, sometimes under the supervision and guidance of delegates from the parent organisation. All long-term goals were limited to what one might expect in the face of a production-for-export mandate.

The paper company sought to increase its production to 4,000 tons of paper within the year. The plaster company sought to increase its production to 8,000 units within the year. Its manager also had full manpower-planning authority and was able to set his goals accordingly. The Computer Manufacturing Company's goal was the production of 120,000 units annually. Its other goals addressed cost control, wages, sales, rent-reduction, quality, and meeting ISO 9000 standards.

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Environmental Analysis

This was a particularly difficult subject to touch upon. The managers tended to see this as a political issue, as irrelevant to their roles as managers and as outside their ability to control. As a result, they were not inclined to discuss it. For example, they related only minimally to matters affecting the external environment, such as government regulations, pollution, energy, inflation, and the like. They considered these to be the concern of their headquarters. Their concern was to meet their own specific goals.

They regarded the internal environment, as it pertains to overall organisational dynamics, as beyond their proper role because of their position as separate, insular entities of much larger foreign organisations. Although they could readily identify their own strengths and weaknesses they did not see this as an ingredient of strategic management. However, they were quite comfortable and knowledgeable in discussing their competitive environment and readily identified their major competitors. At the same time, there was no attempt to analyse the environment systematically. The information they did obtain was on a random basis from sales data, customer complaints, media comments, etc.

Jiang's plan to disband almost all of China's wholly or partially state-owned enterprises would seem to be a matter of major significance, particularly in terms of competitive posture within the external environment, but it did not inspire much comment among the managers.

Strategy Formulation

Except for the food processing company, the managers stated that they had no authority to formulate strategy, despite the fact that this element of strategic management is generally considered critical to a company's success or failure. They were primarily charged with implementing what strategic formulation had been imparted to them by their foreign parents.

For example, the plaster manufacturer said that most of its activities, including production and brand name imaging, were supervised by personnel of its headquarters. Not surprisingly, only about one-quarter of its total production is sold in China. However, it expects a promising future there and feels that a low-profit-no-loss strategy is acceptable if not desirable. In the near future, it expects to relocate in order to diversify its product base and to increase its revenue by half. As directed by its parent, it pursues a high-quality-competitive-price strategy.

The paper manufacturer expressed no interest in strategic issues because all of them are decided by its headquarters in Japan. This is because most of its production is exported to Japan for distribution. It said that, to maintain its high quality level, it uses only imported materials, primarily from Japan. Its interest in China centres on low cost labour. A recent visit

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from headquarters officials disclosed that they are interested in targeting the Chinese domestic market, which they would view as a major strategy shift.

The food processing enterprise was unique in that it sells all of its products in East China. In addition, the manager has some authority to formulate policy, but it is limited. Although he meets with upper level regional managers periodically, he is often not obligated to adopt their suggestions. The strategy that he has been able to develop is threefold and consists of strict quality control, creating a brand name rather than a low price image, and reaching end-users, i.e. retailers rather than wholesalers. As a result, prices are reviewed every five days and sales meetings are held monthly. Substantial efforts are made to nurture potential end-user customers and thus shift the firm's market mostly to retail targets. To do this, this manager reported that a "push" strategy is necessary because many potential customers are farmers who raise poultry as a side business, and they are not familiar with the firm's products.

The computer hardware manufacturer receives all of its strategic planning from its headquarters, which is based on high quality, research innovation and strong customer ties. Except for sales management, which is independent, the firm pursues a unified organisational structure that consists of external relations, networking, company imaging, and financial management. Its products (hardware and service) are sold through the Internet twenty-four hours per day.

Strategy Implementation and Feedback

Although the firms interviewed had little or no authority to formulate policy, the authority to implement policy was given in rather substantial ways. The managers had considerable independence in creating such things as operational procedures, rules, committees, specific goals and the like. They also had authority to request, select and allocate human resources. Further, they did not seem concerned about how their headquarters viewed their management styles. What was important was whether they had achieved their goals. With such latitude, some of the managers saw an opportunity to demonstrate their personal leadership qualities and to express their management philosophies. Often, they claimed credit for creating a distinct corporate culture within their firms, a result made possible because of the relative youth of each firm. For example, the manager of the food-processing firm stressed the financial stability of its employees, the success of the enterprise and the welfare of society.

Some managers combined Chinese and Western management styles in order to achieve their goals, recognising the Chinese penchant for group activity and consensus. Although, in some instances, group productivity reports were posted on bulletin boards to promote competition, reports of individual productivity were not exhibited. Employees at supervisory level and above were sometimes permitted to offer suggestions for improvement

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in both the product and policy areas. If favourably reviewed by related departments, they were submitted to the firm's regional headquarters for consideration.

All of the managers claimed authority to select their own employees using their own guidelines. All ranked age and education among their top considerations. All stressed the importance of hiring young college graduates with no prior experience so that they would readily adapt to the firm's own corporate culture with a minimum of resistance. Most of the managers said that they paid competitive wages and used both internal and external sources for training and promotion purposes.

Generally speaking, WOS managers seemed to have less authority than IJV managers. The paper manufacturer and the plaster manufacturer, both subsidiaries, had the least autonomy of all.

Control and Evaluation

In all cases, the manager's approach to strategic evaluation was very limited and simplistic. In fact, they seemed to lack an understanding of the concept. Their methods did not focus on a holistic strategic evaluation as such (assessing the strategic and financial success of the company as a whole based on the implementation of its current strategies). Instead, they concentrated on specific evaluation techniques, such as financial and quantitative measurements, increases in annual sales, decreases in production costs, and on public image and reputation. It was clear that attempts by managers to adopt new management techniques were largely dependent on the degree of autonomy given them, and this varied within the limited parameters imposed on them individually.

All of the managers interpreted strategic evaluation to primarily mean employee evaluation, both individually and in groups. This was also based on quantity measurement, for example, the number of units of production in the case of the plaster, paper and computer manufacturers. However, the paper manufacturer, whose parent was a Japanese company, also used product quality as a basis for evaluation (the Japanese parent had established two quality check points, one in China, the other in Japan).

The use of objective measures in employee evaluations was an important change over the subjective methods the companies had used previously. Another important change was the use of periodic evaluations at all levels of the organisation, lower levels being evaluated more frequently than higher levels. For example, factory floor-workers were evaluated on a weekly basis, supervisors monthly and general managers and assistant managers yearly or semi-yearly. In addition, rewards were tied directly to performance. Another major change was the use of lateral and bottom-up evaluations. This obviously encouraged communication among supervisory and working levels, both vertically and horizontally.

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Discussion and Conclusion

Our research reveals that the transfer of strategic management know-how from foreign companies to their wholly owned subsidiaries has ranged from "minimal" to "moderate."

Except for their obvious ability to implement directions supplied by their foreign parent, the managers had no real grasp of the scope or content of what is known elsewhere in the world as strategic management. For example, most had little knowledge of what a mission statement consists, confusing it with corporate culture, and most tended to equate control and feedback with employee performance. More importantly, they seemed bewildered by the notions of environmental analysis and strategy formulation. With respect to the former, they regarded the external environment, particularly in the regulatory, societal, energy and pollution areas, as a given over which they had little or no control, and therefore of no concern. An exception was their acute awareness of the identity and comparative success or failure of their competitors. With respect to the internal environment, their interest seemed passive at best. This was due, in all likelihood, to the fact that they themselves are insular, distant entities of a much larger, foreign organisational structure.

The "strategies" they had employed were not systematic, in-depth, multi-disciplined or sophisticated. On the contrary, they were either of the "common sense" variety that require no particular skill or training and are therefore self-limited, or were of a tacit nature that often results from the simple interaction between parties pursuing a common goal. From the current study, therefore, we also conclude that whatever transfer of strategic management know-how may have occurred, it was not by design.

There was little difference between the wholly owned subsidiaries and the joint ventures, except that the IJV managers seemed to have more executive authority. This is probably due to the fact that the latter have to interact with partners of equal status who often have differing viewpoints. Managers of wholly owned subsidiaries are far more able to concentrate on operational details as self-contained extensions of their foreign parents. In any event, the effect on the willingness of the foreign company to transfer its strategic management know-how seems to be the same in both instances. There are at least two possible explanations. First, the level of strategic management authority delegated is, in both instances, too low to make any measurable difference meaningful. Second, what the Chinese government may lack in organisational control over the foreign wholly owned subsidiary is often offset by its ability to restrain or empower its operations through licensing, corporate charter requirements, activity reporting, and the like. The inhibiting effect is the same from the viewpoint of the foreign company solicitous of safeguarding its know-how.

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The fact that the status quo seems to be frozen in time can be attributed to three related factors: (1) lack of motivation on the part of the foreign parent because of non-access to the Chinese domestic market; (2) the status of the Chinese subsidiary as a mere profit-centre at the operational level; and (3) the restriction of the Chinese subsidiary to a mere low-cost production-site for export from China, as necessitated by Chinese quota and tariff regulations. In short, there is no reason for the foreign company to consider its Chinese affiliate as a market-penetrating or market-protecting vehicle. Such a function, of course, is the *raison-d'etre* of strategic management know-how.

Thus, interesting questions and possibilities arise for both academicians and practitioners as they consider the environmental changes that will gradually but inevitably occur with China's membership in the World Trade Organisation. Foreign investors will no longer be dealing with an insular mindset that can afford to concern itself solely with its own interests. They will now be dealing with one whose membership obligates it to pursue the policies and rules of a transnational trade organisation whose objective is the welfare of all of its members. Thus, in so vigorously pursuing its membership in the World Trade Organisation, China will be presumed to understand that its "Open Door" policy must work both ways and that all WTO members are subject to sanctions if they do not comply with the rules the organisation prescribes. As is well known, these rules include the elimination of quotas, the reduction of tariffs, and the removal of trade barriers in general (Wong, Maher & Luk, 2002). It seems fair to assume that this process will be catalysed as Beijing prepares for its recent award of the 2008 Olympics.

Practitioners who foresee the inevitable and significantly increased opening of China's domestic market and who wish to optimise their chances of penetrating it may see Chinese partners or subsidiaries as especially capable, by position, language, culture and focus, of achieving that result if strategic management know-how is transferred to them.

Academicians, in considering that the transfer of strategic management knowledge in China has been minimal and undesirable in the past but may be seen as attractive in the future, have a number of research-worthy questions open for their consideration. For example, to what extent is the transfer of strategic management know-how inhibited when the Chinese component is state-owned or state-controlled, partially or wholly? Or to what extent is it inhibited when the government selects the Chinese component or controls the appointment of its officers and directors? Or to what extent is it inhibited when access to China's domestic market is restricted, directly or indirectly? Or to what extent is it inhibited when the Chinese component is a subsidiary rather than a partner? Or to what extent is it inhibited when the Chinese component is not trusted? Or to what extent and on

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what assumptions will China's membership in the World Trade Organisation encourage the transfer of strategic management know-how to the Chinese partner or subsidiary?

The complex implications of China's WTO membership cannot be fully foreseen at this time. While some remain skeptical of China's ability or willingness to adhere to its WTO commitments, many view the matter optimistically, noting China's solid track record of economic reform for more than two decades. What has been certain is China's persistence in achieving such membership and the willingness of most WTO members to grant it.

In any event, a new set of dynamics of major import now come into play. They will tend to align China's thinking on international trade with that of other major free-market players who, when operating in each other domain, tend to transfer considerable strategic management authority to their host country partners or subsidiaries. We cautiously predict that this will now occur in China for similar reasons, but the accuracy of this prediction must necessarily be left to future events and further research.

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