

BOARD BRIEF CHINA

Balancing Flexibility and Control:
Optimizing Your Organizational Structure in China



BALANCING FLEXIBILITY AND CONTROL OPTIMIZING YOUR ORGANIZATION

China presents great opportunities for global corporations, but also great challenges to some of their traditional decision-making structures. Cultural differences and rapid change in China mean that headquarters-oriented organizational systems used in Europe or the U.S. may not be flexible enough for China. At the same time, empowering local managers too much can lead companies to stray from standards protecting core corporate values. Extra risk controls and increased board attention to corporate education and in-country leadership selection may be required. In this Board Brief, Global Navigation examines these challenges and how companies can strike the right balance between flexibility and control.

After more than 20 years in China, Otis Elevator has learned to ride the ups and downs of operating in a country where it is vitally important to understand and work within the culture of its customers.

Today, Otis sits atop the Chinese elevator market, and Otis China President Lindsay Harvey says a critical ingredient was empowering country-based management—a decentralizing strategy not used by some Otis competitors.

“It is the freedom to act within the marketplace,” says Harvey. Three of their brands in China have extensive networks of agents and distributors who provide up-to-date intelligence about customer preferences. “If they find the product—doesn’t have features, they very quickly put those features onto the elevator.”

But as Otis found out, there is also such a thing as being too close to the market in a rapidly developing economy where the business culture differs significantly from a Western investor’s home country.

Some employees “had some bad business practices, which I think was because they were so close to the marketplace that they actually crossed the line,” says Harvey. “We cleaned out all of those people, which has had an impact on the business in terms of bookings and orders. But I think it’s again cemented this notion of how we do business.”

For directors and senior executives of other companies, Otis’ experience provides an important insight as they grapple with a key issue in China: how to adjust the business model to leverage local knowledge while preserving critical global corporate standards and procedures, and all the while, maintaining an acceptable risk profile.

“When you are operating in an emerging country, because the environment can differ significantly from more developed countries, the empowerment of local management has to be stronger,” says Clarence Kwan, National Managing Partner of the U.S. Chinese Services Group of Deloitte LLP.

“But on the other hand, when you empower local management, you might be at risk of letting go too much,” Kwan says. “So the question is, with higher level empowerment of local management, how at the same time do you not compromise

TROL: AL STRUCTURE IN CHINA

overall risk management. That is the trick.”

In this Board Brief, *Global Navigation* examines what companies are doing organizationally to meet that challenge. We look at:

- Key differences in the Chinese marketplace, including the nature of business relationships and the impact of rapid economic change;
- Some of the structural devices companies are using to empower local managers, including matrix approaches with multiple reporting lines;
- The boundaries companies draw to maintain certain established corporate standards despite the differences in China, and the additional risk control measures some employ to counter potential corruption and challenges to intellectual property rights; and
- Two areas demanding special attention for boards: making sure the company is sufficiently educated about China and ensuring that proper focus is applied to leadership selection for the China market.

To help shed light on these issues, *Global Navigation* spoke with key leaders of companies experiencing success in China, as well as experts on doing business in the country.

Our findings are, of course, framed by the caveat that there is no single answer to striking the right balance of power between global headquarters and local management. Among the factors to consider are the kinds of activities a company is undertaking in China, the quality of its local leadership, the company’s size, how long it has been operating in China and the proportion of its business that China represents.

THE CHINA DIFFERENCE

Understanding the disparity between the Chinese approach to relationships and Western norms is critical to effective operations in China, as is adapting to the country’s rapid pace of change.

The first question any corporation might ask when entering China or reviewing its position there is this: Is China so different that we need to change our approach?

For many companies, there may be a strong inclination to go with a model for problem-solving and decision-making that has proven itself elsewhere in the world. Some choose, quite

successfully, to have global business units run their operations in China just as they would in Europe, the United States or anywhere else.

But many others find that there are powerful reasons to adjust the mix and push more power to China-based leaders.

“There is definitely an increase in the number of in-China country manager positions,” says Michael Barbalas, president of the American Chamber of Commerce-China, based in Beijing. Those country managers often coordinate the activities of several business units and have responsibility for promoting corporate values and standards.

While there are lots of contrasts between China and Western countries, two stand out from a business perspective: cultural differences in the way people view interpersonal relationships and the speed of change. Having in-country managers with an understanding of these differences and the authority to make adjustments can be important to business success.

The difference in approach to relationships is illustrated by traditional attitudes toward decision-making, according to Kwan.

“In Western culture, when you are asked to make a decision, your thinking process goes first, ‘Am I doing something legal?’ Second, you ask ‘Is it reasonable for me to do it?’ Then finally, ‘what is my relationship to the person who asked me for this decision?’ If they are close to me, I might speed up the process, but it will not drive the ultimate decision.

“In China, it generally went in the reverse order—relationship, reasonableness, legality. First, I look at who asked me the question. If the relationship is really strong and if the request is reasonable, I may not care if the request is legal. If, for example, my father asked me to do something nice for the family, whether it is legal or not may not factor into my decision at all.

“This different approach to decision-making may also explain why a Chinese businessman would not hesitate to request for a contract renegotiation when circumstances change. To them, a contract has to be reasonable and appropriate to the relationship under the circumstances.”

A second factor that makes China different from many other markets is the speed of change.

Evidence is everywhere, from construction cranes on city skylines to economic statistics. China's gross domestic product increased almost 12% in 2007 and growth has averaged just under 10% per year since 1979.

"Two things drive speed in China" from a business perspective, says Barbalas. "One is Chinese competitors. For example, a Western company building a new factory typically will take 18 to 24 months to break ground, to get it into production. Chinese entrepreneurs will do the same thing in maybe nine to 10 months. They make decisions very quickly and they have very lean management structures typically. So if you've got a complex, slow process you can often have someone run around you.

"Plus, the rate of change in China is often very fast. Government policies shift, and you need to be able to shift with those. Often there are business opportunities in China because of a shift in government policy or a change in direction, and the opportunity to take advantage of that may only be a year to three years."

HOW SOME COMPANIES ARE ADAPTING TO CHINA

To balance the empowerment of local managers against the preservation of corporate standards, some companies are choosing a matrix structure, in which managers in China report up along multiple paths.

Companies adjust their problem-solving and decision-making structures to China's unique conditions in a variety of ways—too many for them all to be described in this Board Brief. But the principal question is how to balance the influence of established corporate methods represented by the global business unit or corporate headquarters against the market knowledge of China-based management.

Too much influence by headquarters can yield a China operation that has difficulty responding to local conditions promptly or appropriately. Too little influence by headquarters can produce an operation that doesn't take advantage of proven methods that increase effectiveness and safeguard corporate values.

Cummins Inc. tries to get the best of both worlds with a matrix structure. The Columbus, Indiana-based manufacturer and distributor of engines and power generation equipment has four global business segments, each with a leader who reports to the company's President/COO, Joe Loughrey. In most countries, those business segments run their own operations. But those operations in China, India and Russia are overseen by Steve Chapman, who as Group Vice President—Emerging Markets and Businesses also

reports to Loughrey.

For formal accounting purposes, results are reported up through the business units. The company also tracks total country results for management purposes.

Capital decisions for China, on the other hand, flow through the business units, with Chapman and John Watkins Jr., Chairman and CEO of Cummins (China) Investment Co. Ltd., lobbying for their projects. There are other mixed reporting lines as well. China Human Resources, for example, reports directly to corporate headquarters with a dotted line to Chapman.

The advantage of the Cummins set-up is that the Emerging Markets group does projects that Chapman believes the global business units would not undertake.

"We've actually had a couple of joint ventures—that would have been killed if it were a business unit project," Chapman says. "But because we have more of a broader corporate focus—thinking about the future of emerging markets, emphasizing the importance of growth in these areas, we were able to forge ahead with the project—and it turned out to be pretty profitable."

"In a corporation, if you go back to individual business units, their tendency would probably be to control rather than partner. So one rationale for this particular group as well is to nurture the partnerships," says Chapman, a Mandarin speaker with more than 15 years experience working in Asia.

Watkins, who has a similar background, believes another key to success in Cummins' matrix system is the ability to sit down locally and resolve problems quickly when business units disagree, rather than escalate the problem to headquarters.

"We're able to move faster, we're able to understand the China market and go after opportunities together and make tradeoffs."

For Cummins, which has four large joint ventures in China, the proof of its organizational structure is in the results. Total revenue in China tripled between 2003 and 2007. China revenue was \$1.7 billion in 2007, and the company is forecasting \$3 billion in 2010.

Tim Solso, Cummins' Chairman and CEO, says their success would not have happened without the matrix structure.

"We would have taken too long to make some of the decisions to take advantage of some of the opportunities as they availed themselves. So by having this structure we were able to move quickly and I think with better judgment."

Barbalas says a critical success factor in a matrix structure is having the key executive for China

report to a senior leader of the corporation, such as the CEO or COO, just like the heads of the global business units.

“When a business gets to a certain size in China, there are synergies between what the business units are doing in China, particularly in government relations, public relations, taxation, some of the legal stuff. But you need somebody who’s got the ear of the CEO, corporate headquarters, to really make it work.”

Barbalas used to be managing director of Andrew Telecommunications (China) Co. Ltd. and spent some time in that role talking to other companies about organizational models in China, including the matrix.

“One of the things I found was that some companies had this structure in China only. In most other places in the world it seemed that a global business unit focus worked well, but I think in China there’s still enough lack of transparency, there’s still enough uniqueness to the market that having some kind of coordination across business units gets the greatest synergies, the best results, for the company.”

MAINTAINING CORPORATE STANDARDS

As important as it is to adapt to the Chinese market, it can also be critical to keep some things the same in Beijing as New York, and often this requires extra risk controls.

Even at some of the most locally-driven companies, corporate standards play an important part.

Otis, a unit of United Technologies Corp., operates four brands in China—Xizi Otis, Express, Sigma and Otis—each with its own leadership structure.

“Individual business units are really driving their own ship under a pretty well-defined corporate structure in terms of some basics like safety, business practices and financial controls,” says Harvey, the Otis China president. “Those things are absolutes. But there on after there is quite a bit of freedom for individual business units to drive their own course.”

“So, for example, the product testing and the product quality is a prerequisite for all the brands. If I take Express, for example, they cannot go off and make an unsafe elevator—but they can source a different product, provided they’ve done that testing.”

Depending on the company and its circumstances, the mix of corporate versus local influence changes.

AON, a global insurance broker and consultancy based in Chicago, has its rapidly growing China

operations reporting both to Asia-Pacific regional headquarters and to the global business units. That is particularly valuable in projects where AON is serving a foreign-based company with operations in China, says Bernie Fung, Chairman & CEO at AON Asia-Pacific.

The global business unit can work with the customer’s headquarters while the China-based unit can handle local arrangements.

Nonetheless, control of some functions remains with corporate headquarters. A key focus of corporate power is in supply chain integrity, says Fung.

“From our standpoint, supply chain integrity comes from the insurance companies we deal with,” he says. China and regional management may work to bring insurers on board, but the final decision goes to AON’s Chicago headquarters.

“Corporately, AON has a security committee that is responsible for vetting the financial security of insurers we work with to make sure we are not going to place insurance with financially shaky organizations,” Fung says.

At Otis, despite the emphasis on adapting to the market, uniform corporate procedures on safety are used.

“We apply the same standards as you’d have in New York or in any other city around the world,” says Harvey. “The same safety rules, the same procedures, the same personal safety protective equipment, everything we would give to a mechanic in a developed country, we do the same here.”

In general, says Deloitte’s Kwan, the influence of the business unit in China should be strongest in operating areas that are revenue or cost-related. “But where there is investment of corporate assets, by which I mean capital but also talent and brands,

FIVE QUESTIONS DIRECTORS MIGHT ASK ABOUT HOW THEIR COMPANY IS SET UP TO OPERATE IN CHINA

- 1 Are senior executives, and the board itself, sufficiently educated about China to take advantage of the unique opportunities, as well as extra risks, posed by market differences?
- 2 Has sufficient attention been paid to the selection of country leadership in China, given the challenges posed by rapid growth, cultural differences in business relationships and the need to maintain a strong connection with global headquarters?
- 3 Are extra risk control measures needed for Chinese operations, particularly to deal with corruption and violations of intellectual property rights?
- 4 Does the organizational structure facilitate the correct balance between responsiveness to local conditions and preservation of corporate values?
- 5 If the company is employing a matrix structure with multiple reporting lines, is there sufficient clarity around who is responsible for decisions and who is accountable for results?

co-ordination should be at the overall corporate level. I would also place much of the burden of corporate compliance at the headquarters level as it is difficult to rely on each business unit to police their own work.”

Still, there are gray areas, and a key consideration for boards is how much risk to take in making adjustments to meet local conditions.

“There are two contending thoughts,” says Prof. Ray Friedman of Vanderbilt University in Nashville. “There’s sort of the play by the locals game. It’s what one executive calls the ‘New Jersey rules.’ Don’t do anything there you wouldn’t do in New Jersey, which is don’t act stupid.

“Lots of people say things just don’t happen the right way. You can’t expect it. Others say the Chinese might try to bait you and deceive you and get you to do dumb things by telling you that’s how it’s done here in China, but don’t get stupid just because you’re in China,” says Friedman, who studies business practices in China as the Brownlee O. Currey Professor of Management at the Owen Graduate School of Business.

So what are some of the risks of empowering local management, and what can boards do to deal with those?

The top risk for Western companies doing business in China is corruption, Barbalas believes.

“There are lots of opportunities for corruption and diverting things away from where they should be going,” he says.

Otis’ Harvey agrees.

“There are huge, huge challenges within China and across Asia.” he says.

There are several risk management techniques that boards may wish to look at, including heightened screening of job candidates, increased segregation of duties and training in company values.

In the financial area, Otis segregates duties more than other places in the world because of the high risk.

“We’ve put in the processes and the procedures to try and eliminate the risk, but we still have cases raised every month with us,” Harvey says.

That segregation of duties is a key safeguard to protect against the risk posed by the cultural emphasis on relationships, says Kwan.

“The additional segregation of duties actually helps the people out so they know when to say no. Basically, if one of their relatives asks them to do something, they can say ‘This is outside of my authorization. I cannot do it. I have to run it by somebody else,’” he says.

“There you see the benefits of a good system. A good system allows you to say no without antagonizing a relationship.”

Otis practices another risk control measure in the area of business practices that other companies may wish to consider: geographic selectivity.

“Some cities are much easier to do business in than others,” says Harvey. “And in some of those areas if we choose not to do business, we just allow that to be done by someone else.”

Companies also undertake values training. “You try to instill your corporate culture and your corporate values not just into your company, but into your supply chain as well,” says Barbalas. “If a vendor is found to be paying off a purchasing person, they’re just not going to do business with us.”

“It’s training your suppliers as well. On the customer side, it’s explaining to them that we are not going to pay bribes, we are not going to do things inconsistent with what we believe and get us in trouble with the Foreign Corrupt Practices Act.”

Another key risk area for Western companies operating in China is theft of intellectual property. The risk question is how much access to critical information should be given to local employees and suppliers.

Finding the right risk control solution depends to a great extent on a company’s strategy, says Vanderbilt’s Friedman. In some cases, say with rapidly evolving consumer goods, loss of intellectual property may not be a huge problem compared with the advantages of being close to the market. In other cases, companies will want to take a hard line and exercise strong corporate control over access to intellectual property.

“The extreme I’ve heard of is companies that would have a chemical plant (in China), with the software to determine the mix of chemicals operated in Ohio by internet so no one on site even knows,” says Friedman. “If everyone there were hired away they still wouldn’t have the answer because no one on site actually controls what the mix of chemicals would be.”

At the other end, one can just accept that theft will occur, says Friedman.

“You invest more heavily in speed of innovation on the inevitability of having it stolen. And (if you) figure there’s a one-year lag before they can copy effectively, then one strategy might be investing even more in R & D because as long as you can come up with something new every year you’ll be a little ahead of them anyway.”

A more middle-of-the-road approach would be to follow the model for financial controls and stress segregation of duties and knowledge.

Barbalas took one such approach in his days at Andrew Telecommunications.

“When we were doing our component outsourcing, we made sure certain components

went to one province to suppliers and others went in another direction. And no one had a whole set of drawings.”

And, as in the financial area, Barbalas also believes it is important to educate employees on company IPR values.

“You can institute all the segregation, physical access control, document control, but in a company of any size, if you haven’t systematized this stuff and haven’t built it in to your corporate culture, there’s no way you can follow every transaction.”

Another area of risk comes from using the matrix structure, which in itself can be a type of risk control device.

While multiple reporting lines can create checks and balances, they also can spawn confusion in communication and decision-making.

Both Chapman at Cummins and Fung at AON acknowledge some difficulties in clarifying decision-making, and both say their companies are working to increase clarity.

And Barbalas says, “One of the complexities people struggle with is who are you responsible to, and what are you responsible for?”

“The companies that do it best focus a lot on getting the right people in those positions because the matrix structures, the overlapping—and it can go down a couple of levels—it just doesn’t work unless you’ve got good people who work together in those positions.”

THE BOARD’S ROLE

As companies empower in-country management in China, the board has two critical roles: to insure that senior management has sufficient knowledge of China to effectively oversee those local leaders and to pay extra attention to their selection.

Besides making sure that appropriate controls are in place in country, boards have two other key ways of maintaining an appropriate risk profile in China: making sure there is sufficient knowledge of China at senior levels in the corporation and making sure the right leadership team is in place.

Having the right country leadership is particularly important in a situation where local knowledge is a critical factor, according to Barbalas. That’s because the same top leaders not only have to spearhead efforts to exploit opportunities generated by local conditions, they also have to take the lead on recognizing special risk factors and putting controls into place, he says.

He believes one must ask, “Do you have the managers to do the execution, but do you also have the leadership to have that part of the company behave in a way that’s consistent with the company’s best interest and consistent with what you want to do?”

“That’s where that trust by the CEO, COO becomes critical, because it’s not going to be like walking down the hall and asking the person a question. They’re going to be off far away. It’s hard to check up on them. There has to be a certain level of trust.”

“They’ve got a lot to do. And it has to get done very fast. So those jobs are really very high pressure jobs. This is all while businesses are growing 20 percent a year,” Barbalas says.

Cummins CEO Solso also sees China leadership as critical.

“It’s very difficult for somebody that’s running a business here on a global basis to know the culture—how things are done in China and so forth. Having the troops there that know what they are doing and can advise the business units in terms of what to do and are capable of making decisions really made us much more agile.”

“The personnel involved and their experience is almost as important as the structure you use,” Solso says.

The other critical thing the board needs to worry about is the understanding of China at corporate headquarters, Barbalas says.

“I’ve talked to some Fortune 500 CEOs who said they’re putting the equivalent of C-level executives in China for a year or two just so that there’s more understanding of China, there’s more factoring of China into decision-making at corporate headquarters.”

“I see a lot of CEOs now from very large companies who are routinely coming to China twice a year. I see boards that are having their board meetings in China every couple of years. That’s to make sure that the board is really getting the information that it needs.”

OPTIMIZING YOUR ORGANIZATIONAL STRUCTURE IN CHINA—SUMMARY

To balance the empowerment of local managers against the preservation of corporate standards, some companies are choosing a matrix structure, in which managers in China report up along multiple paths.

In light of the unique conditions in China, companies may wish to review their organizational approach and ask whether they are striking the right balance between empowering local management and control by headquarters.

One size does not fit all, and any structure must be shaped by a particular company’s circumstances. With the proper leadership and risk controls in place, companies can maximize opportunities with an optimal organizational framework that empowers in-country management to leverage their understanding of Chinese culture and the rapid pace of change in China’s business environment.

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In China, we offer a number of board services from individual board meetings in China to director trips. Global Navigation will take approximately 35 CEOs and directors to China, October 25-31, 2008. This trip will focus on U.S. and European businesses that are successfully doing business in China.

Participants will explore how companies are selling to Chinese businesses and consumers, dealing with human resource and compensation issues, and navigating the legal and regulatory structures in China. Our group will meet with VCs and will explore how the private equity community is working in China. Our directors and officers will have selected peer exchanges with Chinese CEOs and directors. There will be discussions on how to manage risk and align corporate governance practices in this growing market.

Please see our website www.globalnav.com for more details.

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